FEDERAL RESERVE press release

For Use at 4:30 p.m. September 23, 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 August 16, 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 August 16, 1988

Domestic policy directive.

The information reviewed at this meeting suggested that the economy was continuing to expand at a vigorous pace, with manufacturing activity exhibiting particular strength. Some measures of price inflation pointed to a pickup from recent trends, and data on wages and total compensation indicated that labor costs were rising more rapidly.

Total nonfarm payroll employment increased sharply further in June and July. The rise included continuing rapid expansion in the manufacturing sector and it was accompanied by an appreciable increase in the workweek of production workers. After declining considerably in June, the civilian unemployment rate edged up to 5.4 percent in July but remained slightly below its average level for the second quarter.

Industrial production rose strongly in July after a sizable advance during the second quarter. Production gains were widespread but were especially pronounced for business equipment. Capital utilization rates in manufacturing rose further in June and July and were at relatively high levels in primary processing industries.

Retail sales increased moderately further in July, and revised data indicated somewhat higher retail sales in the second quarter than had been estimated earlier. Overall consumer spending in constant dollar terms increased at about the same moderate pace in the second quarter as it had on average in the previous three quarters; outlays for services and durable goods posted strong gains in the quarter, while spending for nondurable goods declined.

Business fixed investment was now indicated to have increased substantially further in the second quarter. Spending for business equipment registered another sharp rise, paced by continued large gains in outlays for computing equipment. An upturn in expenditures for nonresidential construction offset about half of the drop in the previous quarter. With outlays for consumer durables and business equipment relatively robust, the accumulation of nonfarm business inventories slowed markedly in the second quarter. Housing starts were unchanged in the quarter from their pace in the first quarter.

The U.S. merchandise trade deficit declined considerably in the second quarter to its lowest level in three years. Exports of both agricultural and nonagricultural goods rose substantially while non-oil imports fell after increasing steadily since early 1985. Economic activity appeared to have slowed in most of the major foreign industrial countries in the second quarter. The rate of inflation had increased in some of those countries in recent months, but it was still relatively low.

Producer prices of finished goods, which had increased at an accelerated pace in the second quarter, rose appreciably further in July. The advance in July included a substantial rise in prices of consumer goods excluding food and energy. The consumer price index, available for June, continued to suggest little change in the rate of consumer price inflation as declines in energy prices tended to offset some acceleration in food and other prices. The prices of some basic commodities had softened recently, in part because of the appreciation of the dollar in foreign exchange markets.

Increases in most measures of labor costs had picked up over the past several months, with the acceleration occurring in most broad industry and occupational groupings.

In the foreign exchange markets, the dollar rose somewhat further over the period since the Committee meeting on June 29-30. In relation to other G-10 currencies, the dollar was up about 2-1/2 percent on average over the intermeeting period. Indications of continuing improvement in the U.S. trade balance and of some tightening in U.S. monetary conditions contributed to the strength of the dollar, but the rise in its exchange value may have been tempered by perceptions that it would be resisted by official actions.

At its meeting in late June, 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 of M2 and M3 at annual rates of about 5-1/2 percent and 7 percent respectively over the period from June to September. The members agreed that somewhat greater reserve restraint would, or slightly lesser reserve restraint might, be acceptable depending on indications of inflationary pressures, the strength of the business expansion, developments in foreign exchange and domestic financial markets, and the behavior of the monetary aggregates. The intermeeting range for the federal funds rate was left unchanged at 5 to 9 percent.

Some slight firming of reserve conditions was implemented immediately after the June meeting. In the reserve maintenance period ending in mid-July, adjustment plus seasonal borrowings jumped to an average of $1.3 billion, reflecting a surge in borrowings over the extended July 4 weekend and another bulge associated with an unanticipated large upward revision in required reserves late in that maintenance period. In the two reserve maintenance periods that followed, borrowings averaged close to $600 million, somewhat above the level prior to the June meeting. Over much of the intermeeting period, federal funds traded primarily in a range of 7-3/4 percent to 7-7/8 percent. In addition to the firming of reserve conditions, market expectations of further near-term monetary restraint in response to the strength of incoming economic data seemed to contribute to the rise in the federal funds rate from its average level in June. On August 9, the discount rate was increased from 6 percent to 6-1/2 percent and at the time of this meeting federal funds were trading around 8-1/8 percent.

Against the background of continuing strength in the economy, related concerns about inflation, and the firming of monetary policy, most other interest rates rose 1/2 to 3/4 percentage point over the intermeeting period; however, increases in yields on corporate and municipal bonds were more limited, reflecting reduced supplies of new issues. Mortgage rates rose marginally during the period. Banks raised their prime lending rate from 9 to 9-1/2 percent in mid-July and subsequently to 10 percent in the first part of August. Broad indexes of stock prices were down around 5 percent over the intermeeting period.

Growth of the broader monetary aggregates, especially M2, slowed in July to rates somewhat below the Committee's expectations for the third quarter as a whole. The weakness in M2 was concentrated in its volatile overnight RP and Eurodollar components. Growth of retail deposits in M2 remained considerably less than in the first few months of the year and apparently was damped by the rise since early spring of market interest rates and related opportunity costs of holding such deposits. M1 continued to expand rapidly in July, with strength especially evident in other checkable deposits. Reflecting a surge in total reserves, the growth of the monetary base accelerated in July.

In the light of recent economic developments, the staff projection prepared for this meeting was revised to incorporate notably faster real growth in the current quarter than had been anticipated earlier. Nevertheless, the rate of expansion was still projected to moderate considerably on balance over the next several quarters. The effects of the drought were expected to depress measured GNP growth in the second half of the year, but those effects would be reversed in the first part of 1989. Growth of final demand was projected to moderate somewhat over the year ahead. To the extent that the current momentum in final demand tended to be sustained but was not accommodated by monetary policy, pressures would be generated in financial markets that would restrain domestic spending. The staff projection continued to anticipate relatively sluggish growth of consumer spending, much slower expansion of business fixed investment, and subdued housing activity. The strengthening of the dollar since late spring might inhibit the improvement in the nation's trade balance to some extent in 1989, but continuing progress in reducing the trade deficit was still expected to provide a key impetus to sustained economic expansion. The rate of inflation was projected by the staff to increase somewhat over the next several quarters, to an important extent because of the effects of reduced margins of unutilized labor and other production resources.

In the Committee's discussion of the economic situation and outlook, a number of members gave considerable emphasis to indications of ongoing strength in the economic expansion and to the implications of such growth for inflation in the context of relatively full utilization of labor and capital resources. Some commented that the surprises in the incoming economic information over the course of recent weeks--indeed for the year 1988 to date--had tended to be on the side of greater than projected strength. Other members gave more weight to the possibility that monetary tightening over previous months--reflected in reduced growth of the monetary aggregates, higher interest and exchange rates, and flat commodity prices--might already have fostered a significant slowing of the expansion and restraint on inflation. The members generally anticipated at least some moderation in the expansion from the recent pace and viewed slower growth as a desirable development in terms of accommodating long-run anti-inflation objectives, but they differed as to what degree of policy restraint might be needed to achieve a sustainable and noninflationary rate of economic expansion.

In their assessment of prospective developments in key sectors of the economy, a number of members focused on business fixed investment and business inventory accumulation as areas of particular uncertainty. Growth in business capital spending was expected to slow substantially from its rapid pace earlier this year, but a number of members believed that the risks of a different outcome were in the direction of unanticipated strength, particularly in light of exceptionally high rates of capacity utilization in many industries. Tending to support that view were a growing number of reports from business contacts of plans to expand or modernize production facilities. Business inventories currently appeared to be at generally acceptable levels, as evidenced by inventory-to-sales ratios, lead times on deliveries, and reports from many business firms around the country. Nonetheless, a surge in inventory accumulation could not be ruled out at this stage of the cyclical expansion. Under prevailing economic conditions, such a development might well add to inflationary demand pressures and could threaten the sustainability of the business expansion itself.

Views with respect to the outlook for consumer spending differed to some extent, but the members generally anticipated relatively limited growth over the next several quarters. One factor cited was the impact of higher interest rates, whose restraining effects on consumer spending might be reflected more quickly than earlier because of the increased use of variable rates on consumer and mortgage loans. Some members commented that relatively slow growth of consumer expenditures would be desirable not only to curb potentially inflationary expansion of overall final demand but to facilitate the allocation of more production resources to export markets. The rise in mortgage interest rates was expected to damp housing activity, and one member emphasized that this effect might be quite substantial.

With regard to the prospects for foreign trade, the members still expected net exports to continue to improve, but the extent of that improvement might be less than previously anticipated, given the appreciation of the dollar in recent months. Indeed, some business contacts competing in international markets or preparing to enter such markets were already expressing concern about the potentially negative impact that the rise in the dollar would have on their sales.

Turning to the outlook for inflation, members noted with particular concern that labor compensation costs were rising at a faster rate this year. Several commented on increasing shortages of workers in their local and regional markets and on more numerous reports of higher wages to attract or retain workers. However, wage inflation did not appear to be worsening in many areas, including some where available workers were reported to be in increasingly short supply. With regard to price developments, recent statistical indicators presented a mixed picture. Producer prices of finished goods were rising more rapidly and there were reports from some parts of the country that business firms were succeeding to a greater extent than earlier in their efforts to pass on rising costs or to raise profit margins. On the other hand, sensitive commodity prices, particularly for industrial materials, had been fairly steady and a firmer dollar should relieve some of the pressure on import prices. On balance, however, most of the members thought that the risks were on the side of greater inflation over the quarters ahead.

At its meeting in late June the Committee reviewed the basic policy objectives that it had set for growth of the monetary and debt aggregates in 1988 and established tentative objectives for expansion of those aggregates in 1989. For the period from the fourth quarter of 1987 to the fourth quarter of 1988, the Committee reaffirmed the ranges of 4 to 8 percent established in February for growth of both M2 and M3. The monitoring range for expansion of total domestic nonfinancial debt was left unchanged at 7 to 11 percent for 1988. On a cumulative basis through July, M2 and M3 grew at annual rates a little above the midpoints of their annual ranges. Expansion of total domestic nonfinancial debt appeared to have moderated to a pace marginally below the midpoint of its range. For 1989 the Committee agreed on tentative reductions to ranges of 3 to 7 percent for M2 and 3-1/2 to 7-1/2 percent for M3. The monitoring range for growth of total domestic nonfinancial debt was reduced to 6-1/2 to 10-1/2 percent for 1989. It was understood that all the ranges for next year were provisional and that they would be reviewed in February 1989 in the light of intervening developments. With respect to M1, the Committee reaffirmed in June its earlier decision not to set a specific target for growth in 1988 and also decided not to establish a tentative range for 1989.

During the Committee's discussion of policy for the intermeeting period ahead, nearly all the members indicated that they preferred or could support a directive to maintain unchanged conditions of reserve availability. In assessing the desirability of such a policy, members noted that the discount rate had been raised only recently and, to date, financial markets did not appear to have adjusted fully to the increase. In the circumstances, several members expressed concern that further tightening at this time through open market operations might have unintended and unsettling effects on financial markets. Moreover, under prevailing circumstances, further firming might well foster some added strengthening of the dollar in foreign exchange markets with undesirable repercussions over time on progress in improving the nation's foreign trade position. One member also noted that further tightening so soon after the increase in the discount rate would add to pressures for firmer monetary policies abroad and thereby heighten the risks of an upward ratcheting of interest rates in financial markets around the world.

While the members generally agreed on the desirability of a steady policy for the near term, many thought that some further firming was likely to be needed, perhaps relatively soon. These members saw substantial risks that inflationary pressures would intensify in the absence of further fiscal and monetary restraint. The economy had considerable momentum and there already were indications that cost pressures and some prices were increasing more rapidly. In light of their concerns, these members favored a directive that would permit operations during the intermeeting period to be adjusted more readily toward further tightening, if incoming information tended to confirm the potential that they saw for increasing inflationary pressures. While most of these members did not rule out the possibility of some easing, one proposed a directive that did not envisage any move in that direction during the intermeeting period.

Other members, while they could accept a directive that indicated a greater willingness to tighten than to ease reserve conditions, were less certain of the potential need for further monetary restraint, especially in the near term. These members emphasized that, when taken together, the tightening actions over the past several months represented in their judgment a major policy move whose restraining impact was not yet fully reflected in the economy. In this view, time was needed to observe the effects of the earlier policy actions and thus to reduce the risk that monetary policy inadvertently might become too restrictive. Also, a cautious approach to further tightening might be appropriate in light of the fragilities that had developed in the economy, including the vulnerability of many financial intermediaries and the exposure of many business and household borrowers and of some foreign debtor countries to rising interest rates. Other members, while not disagreeing that debtor problems were a matter of serious concern, nevertheless felt that primary emphasis needed to be placed on curbing any tendency for inflation to gather momentum; such a development, if allowed to proceed, would lead to even higher interest rates and more severe damage to exposed, interest-sensitive borrowers, both in the United States and abroad.

In the discussion of factors that might trigger future monetary policy actions, a number of members felt that the behavior of the monetary aggregates should be given more weight, although only a few favored giving primary emphasis to these measures. According to a staff analysis prepared for this meeting, growth of both M2 and M3 was likely to be appreciably slower in the current quarter than had been anticipated at the time of the previous meeting, given the rise in interest rates that had occurred over the intermeeting period. Assuming no further increase in interest rates, the cumulative expansion of M2 through September might be around the midpoint of the Committee's range for the year while that of M3 might be only marginally above the midpoint of its range. Growth of M1 also was expected to slow substantially from its relatively rapid rates of expansion in June and July. Members who wanted to give the monetary aggregates greater attention expressed satisfaction that monetary growth appeared to have slowed to a pace deemed more consistent with progress in reducing inflationary pressures and a sustainable expansion in economic activity over time. They also observed that the behavior of M2 had resumed a more predictable pattern over the past several quarters in relation to aggregate measures of economic performance. However, several members expressed the reservation that more time was needed to assess the ongoing reliability of M2 as a guide for the conduct of monetary policy. A number commented that the major focus in policy implementation should continue to be on incoming indications of inflationary pressures in the economy.

In light of the increase that had occurred in the federal funds rate, including the recent rise following the advance in the discount rate, the members accepted a proposal to raise the intermeeting range for the federal funds rate by 1 percentage point to a range of 6 to 10 percent. The upward adjustment in the range was intended to align its midpoint more closely with the current average level of the federal funds rate. The range for the federal funds rate provides one mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded.

At the conclusion of the Committee's discussion, all but one member indicated that they favored or could accept a directive that called for maintaining the current degree of pressure on reserve positions. The members decided that somewhat greater reserve restraint would be acceptable, or slightly lesser reserve restraint might be acceptable, over the intermeeting period depending on indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets. The reserve conditions contemplated by the Committee were expected to be consistent with growth of M2 and M3 at annual rates of around 3-1/2 percent and 5-1/2 percent, respectively, over the three-month period from June to September. The intermeeting range for the federal funds rate was raised by 1 percentage point to a range of 6 to 10 percent.

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

> The information reviewed at this meeting suggests that economic activity has continued to expand at a vigorous pace. Total nonfarm payroll employment grew sharply further in June and July. The civilian unemployment rate in July, at 5.4 percent, was slightly below its average level in the second quarter. Industrial production advanced considerably further in July. Growth in retail sales remained moderate last month. Business capital spending has continued to grow rapidly. Some measures of prices indicate a pickup from recent trends and labor costs have risen more rapidly in recent months.
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> Most interest rates have increased appreciably since the Committee's meeting on June 29-30. On August 9 the Federal Reserve Board approved an increase in the discount rate from 6 to 6-1/2 percent.

The nominal U.S. merchandise trade deficit fell in the second quarter as exports continued to rise and non-oil imports declined. Over the intermeeting period, the trade-weighted foreign exchange value of the dollar appreciated somewhat further in terms of the other G-10 currencies.

Expansion of M2 and to a lesser extent M3 slowed in July but growth of M1 remained relatively strong. From a fourth-quarter base through July, M2 and M3 have grown at rates somewhat above the midpoints of the ranges established by the Committee for 1988. Expansion in total domestic nonfinancial debt for the year thus far appears to be at a pace somewhat below 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 late June reaffirmed the ranges it had established in February for growth 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 also maintained at 7 to 11 percent for the year.

For 1989, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1988 to the fourth quarter of 1989, of 3 to 7 percent for M2 and 3-1/2 to 7-1/2 percent for M3. The Committee set the associated monitoring range for growth in total domestic nonfinancial debt at 6-1/2 to 10-1/2 percent. It was understood that all these ranges were provisional and that they would be reviewed in early 1989 in the light of intervening developments.

With respect to M1, the Committee reaffirmed its decision in February not to establish a specific target for 1988 and also decided not to set a tentative range for 1989. The behavior of this aggregate will continue to be evaluated in the light of movements in its velocity, developments in the economy and financial markets, and the nature of emerging price pressures.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, somewhat greater reserve restraint would, or slightly lesser reserve restraint might, be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth in M2 and M3 over the period from June through September at annual rates of about 3-1/2 and 5-1/2 percent, respectively. 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 6 to 10 percent.

Votes for this action: Messrs. Greenspan, Corrigan, Angell, Black, Forrestal, Heller, Johnson, LaWare, Parry, and Ms. Seger. Vote against this action: Mr. Hoskins. Absent and not voting: Mr. Kelley.

President Hoskins dissented because he preferred a policy that would give less emphasis to near-term business conditions and exchange rate considerations and greater emphasis to the longer-term objective of price stability. He viewed the current rate of inflation as too high relative to that objective and believed that the strength of final demand and associated pressures on costs in the economy suggested that inflation may be heading higher. In the circumstances, he thought further monetary restraint would be more consistent with the Committee's long-run price stability objective and would increase market confidence in the eventual achievement of that objective.