

FEDERAL RESERVE press release



For Use at 4:30 p.m.

November 16, 1990

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 October 2, 1990.

The record for each meeting of the Committee is made available a few days after the next regularly scheduled meeting and subsequently is published in the Federal Reserve Bulletin and the Board's Annual Report. The summary description of economic and financial conditions contained in each record is 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 October 2, 1990

Domestic policy directive.

The information reviewed at this meeting suggested that economic activity had expanded at a slow pace in the third quarter. The available data provided only limited evidence of a retarding effect of the recent large increase in oil prices on production and aggregate spending. Key measures of inflation had been boosted by the rise in oil prices, but on the consumer level the upward march in prices of items other than food and energy also appeared to have quickened somewhat. Data on labor costs suggested no improvement in underlying trends.

Total nonfarm payroll employment declined in July and August, largely because of layoffs of temporary census workers. Employment in the private sector was little changed over the two months as widespread declines in jobs at manufacturing and construction establishments offset limited gains in the service-producing sector. In the weeks after the August employment survey, initial claims for unemployment insurance moved into a slightly higher range than had prevailed in the preceding few months. The civilian unemployment rate edged up to 5.6 percent in August.

After showing strong gains over the previous two months, industrial production was about flat on balance in July and August. Output of construction supplies continued to fall, but production of consumer goods other than motor vehicles firmed a bit on balance after declining earlier in the year. Total industrial capacity utilization slipped in July and August. In manufacturing, operating rates declined

further in most industries and were appreciably below year-earlier levels.

Consumer spending in real terms was up slightly on balance in July and August; however, averaged over the two months, spending was significantly above the level for the second quarter. Outlays for services rose in August at a pace well below that registered over the previous several months. Spending for motor vehicles and parts fell, but outlays for other consumer goods posted moderate increases. Major surveys of consumer attitudes indicated a sharp deterioration in the confidence of consumers. Total private housing starts declined for the seventh consecutive month. Single-family starts slid further, evidently in response to continued weakness in sales of new homes.

In August, shipments of nondefense capital goods retraced part of a large July decline. Average shipments for the July-August period were below their second-quarter level, which suggested that overall equipment spending remained in a relatively flat trend. Shipments of office and computing equipment appeared to be somewhat weaker, while shipments of aircraft in July were well above their second-quarter average. New orders for nondefense capital goods changed little in July and August from their level in the second quarter, which pointed to continued sluggish equipment spending in coming months. Nonresidential construction put in place increased in June and July, but anecdotal information and other indicators suggested a downward trend in nonresidential building activity, reflecting the persistence of high vacancy rates for commercial properties and the financial pressures on builders and their lenders. Manufacturing inventories rebounded in July

from a sizable June decline; the stock-shipments ratio remained near the lows of the current business expansion. Wholesale and non-auto retail trade inventories expanded in July at a pace near the average rate of accumulation over the second quarter.

The nominal U.S. merchandise trade deficit widened sharply in July from the revised, unusually low rate in June. The value of exports more than retraced its sizable June pickup, with decreases widespread among major trade categories that had risen in June. The value of imports increased in July for a range of commodities, but the total remained below peak monthly rates reached earlier in the year. Higher oil imports in July reflected a rise in the quantity of oil imported as prices paid edged lower that month before turning up in August and September in response to developments in the Middle East.

Markedly higher domestic oil prices in August contributed to substantial increases that month in producer and consumer prices. Producer prices of finished goods reflected a rapid pass-through of the higher oil costs into consumer energy products. Prices of non-energy, nonfood items rose in August at about the moderate average monthly pace evident thus far this year. Consumer prices surged in August, largely reflecting the higher oil prices. Excluding food and energy items, consumer inflation had picked up in July and August from the second-quarter rate; the acceleration resulted from price advances for non-energy services as prices of commodities flattened out in August after rising moderately in July. Average hourly earnings rose in August at a little slower pace; however, over the twelve months ended in August,

hourly earnings increased at about the same rate as that recorded during the previous twelve months.

At its meeting on August 21, the Committee adopted a directive that called for maintaining unchanged conditions of reserve availability, at least initially, in the intermeeting period ahead and that provided for giving emphasis to potential developments that might require some easing later in the period. Accordingly, the directive indicated that slightly greater reserve restraint might be acceptable during the intermeeting period, while some easing of reserve pressure would be acceptable, depending on progress toward price stability, 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 about 4 and 2-1/2 percent respectively over the three-month period from June to September.

With price pressures, even outside of the energy sector, not abating and the economy continuing to advance, albeit slowly, open market operations during the intermeeting period were directed at maintaining unchanged reserve conditions. In the three reserve maintenance periods completed since the August meeting, adjustment plus seasonal borrowing averaged about \$800 million, an amount inflated by circumstances that gave rise to sharply higher federal funds rates and unusually heavy adjustment credit extensions on the final day of each of these maintenance periods. The federal funds rate generally remained near 8 percent over the intermeeting period, but it edged higher late in

the period in the context of quarter-end pressures and more cautious reserve management policies at some banks. Treasury bill rates fell somewhat over the intermeeting period, apparently reflecting heightened investor preference for liquidity and safety, while rates on private market instruments changed little on balance. In the bond markets, yields on investment-grade securities edged down. Interest rates on lower-rated instruments rose considerably, as higher oil prices were seen as presaging a sluggish real economy and greater strains on issuers of such debt. In addition, yields on subordinated debt obligations of some major banking organizations increased sharply, reflecting growing investor concerns about the effects of softening real estate values and sluggish economic activity on the quality of bank loan portfolios. Broad indexes of stock prices moved lower over the period.

The trade-weighted foreign exchange value of the dollar in terms of the other G-10 currencies declined slightly further on balance from the low level reached at the time of the August meeting. The dollar changed little against most major currencies, but it depreciated substantially against the yen as monetary conditions were tightened further in Japan in response to continued strength in economic activity and potential price pressures in that country. Economic growth in the other G-10 countries slowed, on average, in the second quarter, but recent indicators suggested a rebound in some of those countries.

M2 expanded at an appreciably faster rate in August, and available data suggested continued strength in September. M3 also accelerated in August, but its growth appeared to have slowed somewhat in September. More rapid expansion of M1 and a surge in money market

funds, as investors apparently switched out of the stock and bond markets, contributed to the greater strength of the broader aggregates over the two months. Through September, expansion of M2 was estimated to be a little below the middle of the Committee's range for the year, and growth of M3 was in the lower portion of its range. Expansion of total domestic nonfinancial debt appeared to have been near the midpoint of its monitoring range.

The staff projection was prepared against the background of unpredictable developments in the Middle East and the substantial adverse effects of high oil prices on domestic inflation and economic activity. While it was recognized that a range of plausible assumptions could be made about the prospective behavior of oil prices, the projection assumed no further major disruption to oil supplies and an appreciable drop in oil prices in the first half of next year as production expanded world-wide to fill the void left by Kuwait and Iraq. In the interim, the retarding effects of higher energy costs would depress the growth of real disposable incomes and consumer spending. Weaker consumer demand along with uncertainty about the outlook would retard business capital spending. Construction spending--both residential and nonresidential--was expected to continue to decline, reflecting the effects of softer housing prices, reduced credit availability, and high vacancy rates for commercial structures. Under the circumstances, a mild downturn in overall economic activity was projected for the near term. However, the staff continued to anticipate considerable growth in exports over the next several quarters in conjunction with further economic expansion in several major foreign

industrial nations and in response to the substantial depreciation that had occurred in the foreign exchange value of the dollar. The impetus from the external sector and a rebound in consumer expenditures fostered by the assumed drop in oil prices in coming quarters would bring a resumption of moderate economic growth. The projection assumed that deficit reduction measures about in line with the proposal now before the Congress would be adopted. The outlook for inflation remained clouded by the very uncertain prospects for oil prices. The sizable decline in oil prices projected for next year along with the opening up of slack in resource utilization would foster a lower rate of consumer price inflation, but the improvement would be limited by the lagged effects of the decline that had occurred in the foreign exchange value of the dollar.

In the Committee's discussion of the economic situation and outlook, members commented that despite weaknesses in some sectors of the economy and parts of the country, overall economic activity appeared to be continuing to expand, although at a relatively slow pace. Many of the members observed that, insofar as could be judged on the basis of traditional indicators, the available data did not point to cumulating weakness and the onset of a recession. At the same time, however, the risks of a recession were felt to have increased. These risks stemmed to an important extent from developments in the Middle East and the continuing financial strains in the economy that were adding to stringency in credit markets. Business and consumer confidence appeared to have deteriorated considerably, especially since early August. The members generally agreed that some tendency for economic growth to

moderate and inflation to worsen for a time could not be avoided as a result of oil price developments.

Despite the relatively limited growth of the economy and the apparent fragility of the expansion, the prospects for inflation were viewed with concern. To a considerable extent, recent increases in key measures of inflation reflected the pass-through effects of the surge in oil prices, but many of the members felt that the underlying rate of inflation also had worsened even apart from the effects of higher oil prices. Reduced pressures on resources would help to contain inflationary forces, but there was still some risk that upward movements of oil and import prices would intensify inflationary expectations, fostering increases in wages and other costs that would become more deeply embedded in the cost structure of the economy.

Many of the members observed that the recently negotiated federal budget proposal incorporated a significant degree of fiscal restraint, a potentially workable enforcement mechanism, and a desirable multi-year commitment. Final enactment of a budget along the lines of the proposal would establish a sounder basis for a satisfactory performance of the economy. However, the federal budget deficit would still be extraordinarily large, and the commitment to enforce fiscal restraint measures in the future remained to be tested.

In the course of the Committee's discussion, members focused considerable attention on developments in credit markets. The financial strains being experienced currently by many lending institutions reflected especially the problems in the real estate sector, although the buildup in earlier years of debt owed by less developed countries

and the tenuous condition of some highly leveraged domestic business firms tended to aggravate current difficulties. Efforts by banks and other lenders to protect or improve their capital positions in the face of deteriorating loan portfolios were reflected in widespread signs of growing constraints on the availability of credit and increases in its cost, especially to less than prime borrowers that lack direct access to securities markets. This pullback was not limited to domestic lenders; foreign institutions, which previously had been quite aggressive suppliers of funds to U.S. credit markets, now seemed less willing to fill the gap left by domestic lenders. It was difficult to judge the extent of the reduced availability of credit because the weakness in loan growth also reflected an apparently substantial cutback in the demand for credit. In the view of a number of members, the exposure of the economy to a severe downturn in business activity did not stem in present circumstances from potential adjustments of the usual cyclical kind to overcapacity and overproduction, including excessive inventories in relation to orders and sales, but from the possible aggravation of the strains in financial markets, further retrenchment in lending by banks and others, and the increased difficulty of many heavily indebted businesses and individuals to meet and service their debt obligations in a sluggish economy. On the positive side, the financial system and the economy continued to display a remarkable degree of resiliency, and in important respects many financial institutions had improved their ability to resist adverse developments by raising capital and taking

corrective measures, such as adjusting their lending policies and loan portfolios.

In their review of developments in key sectors of the economy and parts of the country, many of the members stressed that a considerable divergence appeared to have developed between available economic indicators, which suggested continued if only sluggish growth, and deteriorating business confidence. Such business attitudes in association with adverse credit market conditions could lead to efforts to curb inventories and cut back on investments and thus trigger the recessionary conditions that underlay current concerns. While business activity clearly seemed to have weakened in some areas of the country, slow to moderate growth continued to characterize business conditions in most parts of the nation.

The prospects for consumer spending remained a key element in the outlook for the economy. Available data indicated that real consumer outlays in July and August were well above the second-quarter average. Nonetheless, there was evidence that consumer sentiment had worsened considerably in response to a variety of developments including a decline in the value of many consumer assets, especially homes in numerous parts of the country, the heavy debt burdens of many consumers, declining employment opportunities in a number of areas, and more generally the reduced purchasing power associated with rising prices of energy. These developments appeared likely to hold down consumer spending for some period of time. With regard to the outlook for business capital spending, commercial construction would continue to be curtailed by widespread overbuilding and constraints on credit

availability. More generally, business concerns about a possible recession and sluggish consumer spending had induced a cautious approach to planned investment spending, although many producers of capital goods reported that their orders, including demand from abroad, were continuing to hold up. Nonetheless, even in the oil industry the sharp rise in oil prices had elicited a quite limited investment response to date apparently because of the uncertainties that continued to surround the outlook for oil prices and the difficulty of obtaining skilled labor, at least in the short run. The outlook for housing construction also was restrained by soft housing markets and the difficulties that many builders continued to experience in securing construction loans. On the other hand, business inventories generally appeared to be at or near desired levels, and while business contacts around the country pointed to increasingly cautious inventory management policies, there was little evidence of any current or impending cyclical inventory adjustments of the sort that had characterized past recessions. Areas of current or potential strength in the economy included agricultural conditions in many parts of the country and demand for exports that continued to buttress many industries. The substantial decline in the foreign exchange value of the dollar over the past year and the prospects for relatively strong economic growth in some major industrial countries pointed to further improvement in the nation's exports, although some members questioned the potential strength of further expansion in some key foreign countries.

With regard to the outlook for inflation, several members commented that inflation appeared to have intensified even apart from

the direct effects of the higher oil prices. There were reports of business efforts to raise prices in markets where demand was relatively vigorous, though it was unclear to what extent competitive forces would permit sizable increases in prices to be sustained. More generally, members expected the decline in the value of the dollar to be reflected over time in greater pressure on domestic prices. Under foreseeable circumstances and assuming no sharp movements in oil prices, whose course remained highly uncertain, overall prices were likely to remain under upward pressure for some time, but the members still anticipated eventual progress in reducing inflation as continued sluggish demand was reflected in diminished pressures on production resources. A major concern in the interim was that the rise in oil prices would become more firmly entrenched in the cost structure of the economy, thereby making more difficult and delaying progress toward price stability.

In the Committee's discussion of policy, a majority of the members were in favor of easing reserve conditions at least slightly during the intermeeting period ahead. In their view, an easing move was warranted in light of the indications that there was a significant risk of a much weaker economy, partly as a consequence of some further tightening in the availability of credit since mid-summer; in this context, moreover, the budget proposal, if enacted, would provide a degree of fiscal restraint. Some of these members emphasized that the stronger expansion of the monetary aggregates in recent months did not seem to reflect a healthier intermediation process or a more accommodative monetary policy, but rather sizable increases in components of M2, notably currency and money market funds, that under

prevailing circumstances appeared to be related to uncertainty about economic and financial prospects and unsettlement in some foreign countries. Growth in the core components of M2 had remained sluggish, and in the view of these members that development tended to reinforce the conclusion that the overall availability of credit had continued to tighten. In these circumstances, many of the members concluded that some modest easing of reserve pressure would represent a stable monetary policy in the sense that such a move would serve to maintain the appropriate degree of overall credit restraint. In the view of most members, any change in reserve pressures should be limited in light of the danger of leaning too far in either direction in circumstances that were characterized by a sluggish economy and upward pressures on prices. It was argued that the Committee should not try to offset, indeed it could not avoid, some tendency for economic growth to moderate and for inflation to intensify as a result of the oil price developments. One member gave more weight to the recessionary risks in the economy and called for the prompt easing of reserve conditions, preferably by more than a modest amount, although an acceptable compromise in this view would be a slight easing move at this meeting to be followed by some further easing upon passage of the new budget.

Members who favored some easing of reserve conditions agreed that it would be desirable to hold such a move until passage of the federal budget package was more certain. The reasons for the easing were not keyed to the enactment of the new federal budget alone but more broadly to developments in credit markets and the economy, with the prospects for fiscal restraint only one element in the outlook.

Nonetheless, market participants expected a monetary policy response to the fiscal policy actions, and a change in monetary policy while the latter were still under consideration might create unnecessary uncertainty and unwarranted reactions in financial markets. The easing could give rise to expectations of a further move once the budget package was enacted. In the view of some members, however, associating any easing move too closely with a fiscal policy action might set an undesirable precedent in terms of producing expectations of similar monetary policy adjustments in the future.

A number of members expressed strong reservations about any easing of reserve conditions under prevailing circumstances. In their view even a modest move toward ease would be undesirable or at least premature in the weeks ahead. These members acknowledged the risks of a weakening economy, but they believed that policy should continue to focus on controlling inflation. In the absence of more evidence that economic activity might deteriorate substantially, such a focus was likely to involve unchanged reserve conditions for a time. In the prevailing circumstances, they were concerned that any easing in the near term would worsen inflationary expectations by tending to erode the credibility of the System's anti-inflationary effort. Thus, such easing might well have the unintended effects of generating upward pressures on long-term interest rates and adding to the downward pressures on the dollar in foreign exchange markets. In support of this view, some members expressed satisfaction that the overall expansion of M2 for the year was well within the Committee's target ranges and according to a

staff forecast was likely to remain comfortably within that range through year-end.

The members also discussed whether any further adjustments in policy should be contemplated for the intermeeting period in the event that a decision was made to implement some modest easing in the near term. A majority opinion emerged in favor of retaining a bias in the directive toward some further easing, but any such a move would need to take account of the response to the initial easing as well as developments in the economy and credit markets.

At the conclusion of the Committee's discussion, a majority of the members indicated that they favored or could accept a directive that called for maintaining the existing degree of pressure on reserve positions for at least a short period after this meeting. It was presumed that some slight easing would be implemented later in the intermeeting period, assuming passage of a federal budget resolution calling for a degree of fiscal restraint comparable to that now being negotiated and the absence of major unexpected economic or financial developments. Subsequently, some slight further easing of reserve conditions could be implemented if such a move was deemed to be warranted by incoming data on economic and financial conditions in the context of an already sluggish economy. On the other hand, the Committee did not rule out the potential need for some slight firming should inflationary pressures appear to be intensifying. In keeping with this policy, the directive provided that slightly greater reserve restraint might be acceptable during the intermeeting period or somewhat lesser reserve restraint would be acceptable depending on progress

toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets. The intermeeting range for the federal funds rate, which provides one mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, was left unchanged at 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 expanded at a slow pace in the third quarter. The recent large increase in oil prices has boosted key measures of inflation and eroded real personal income; however, data available thus far provide only limited evidence of a retarding effect on production and aggregate spending. Total nonfarm payroll employment declined in July and August, reflecting layoffs of temporary census workers; employment in the private sector changed little over the two months. The civilian unemployment rate edged up to 5.6 percent in August. Consumer spending appeared to be about unchanged in real terms over July and August but was at a level significantly above the average for the second quarter. Advance indicators of business capital spending point to some softening in investment in coming months. Residential construction weakened further in August. The nominal U.S. merchandise trade deficit increased sharply in July from the low rate in June. Markedly higher oil prices contributed to substantial increases in consumer and producer prices in August; excluding energy and food items, consumer inflation has picked up from the second-quarter rate. Data on labor costs suggest no improvement in underlying trends.

In short-term debt markets, Treasury bill rates have fallen somewhat since the Committee meeting on August 21, while rates on private market instruments are little changed. In the bond markets, most rates have edged lower on balance over this period. The trade-weighted foreign exchange value of the dollar in terms of the other G-10 currencies has declined slightly further on balance from the low level reached at the time of the August meeting.

M2 and M3 expanded at appreciably faster rates in August; available data for September suggest continued strength in M2 and some slowing in the growth of M3. More rapid expansion of M1 and money market funds has contributed to the greater strength in the broad aggregates over the two months. Through September, expansion of M2 was estimated to be a little below the middle of the Committee's range for the year and growth of M3 in the lower portion of its range. Expansion of total domestic nonfinancial debt appears to have been near the midpoint of its monitoring range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability, 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 July reaffirmed the range it had established in February for M2 growth of 3 to 7 percent, measured from the fourth quarter of 1989 to the fourth quarter of 1990. The Committee in July also retained the monitoring range of 5 to 9 percent for the year that it had set for growth of total domestic nonfinancial debt. With regard to M3, the Committee recognized that the on-going restructuring of thrift depository institutions had depressed its growth relative to spending and total credit more than anticipated. Taking account of the unexpectedly strong M3 velocity, the Committee decided in July to reduce the 1990 range to 1 to 5 percent. For 1991, the Committee agreed on provisional ranges for monetary growth, measured from the fourth quarter of 1990 to the fourth quarter of 1991, of 2-1/2 to 6-1/2 percent for M2 and 1 to 5 percent for M3. The Committee tentatively set the associated monitoring range for growth of total domestic nonfinancial debt at 4-1/2 to 8-1/2 percent for 1991. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

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 progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, slightly greater reserve restraint might or somewhat lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions

are expected to be consistent with growth of M2 and M3 over the period from September through December at annual rates of about 4 and 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, Boehne, Kelley, LaWare, Mullins, and Stern. Votes against this action: Messrs. Angell, Boykin, Hoskins, and Ms. Seger.

Ms. Seger dissented because she favored an immediate easing of reserve conditions. In her view, such a move was needed at this time in light of the spreading weakness in the economy, the growing difficulty being experienced by many borrowers in obtaining credit, and more generally the increasing fragility of the financial system. She also felt that enactment of the deficit-reduction measures now under consideration would provide a desirable opportunity for some additional easing later during the intermeeting period.

Messrs. Angell, Boykin, and Hoskins dissented because they were opposed to the easing of reserve conditions contemplated by the majority. Not only was there a presumption of some easing in the near term, but the bias in the language of the directive suggested the possibility of some further easing later in the intermeeting period. To a considerable extent, this policy seemed to be a response to short-run softening in the economy that was an inevitable outcome of the disruption to oil supplies. By paying close attention to those near-term developments, the Committee risked losing sight of its fundamental objective of controlling and ultimately bringing down inflation. Moreover, the timing of the prospective easing was linked to fiscal

policy actions, and such a linkage could establish an undesirable precedent that could limit the flexibility of monetary policy in the future. Mr. Hoskins also questioned the adequacy of the fiscal policy measures being considered in the Congress and the desirability of adjusting monetary policy in response to the enactment of those measures.