FEDERAL RESERVE press release

For Use at 4:30 p.m. February 8, 1991

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 December 18, 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 December 18, 1990

1. Domestic policy directive

The information reviewed at this meeting suggested that economic activity had fallen appreciably in recent months. A depressed level of consumer confidence and a decline in real disposable income had contributed to sluggish consumer spending. In response to apparent weakness in final demands, businesses had reduced production and employment; these cutbacks were most evident in the motor vehicle and construction sectors, but a broad range of other industries had been affected to some degree. Consumer inflation had moderated recently, largely as a result of some softening in oil prices. Despite the substantial increases in living costs this year, wage gains appeared to have slowed somewhat in recent months.

After a progressive weakening during the first three quarters of the year, total nonfarm payroll employment fell sharply further in October and November. Job losses were widespread across industries in November but were especially pronounced in manufacturing and construction. In the service-producing sector, which had generated most of the employment gains earlier in the year, the health industry was one of the few to post significant increases in jobs. The civilian unemployment rate rose to 5.9 percent in November.

Industrial output declined markedly for a second straight month in November. Production cutbacks were broadly distributed across industries but were especially pronounced in motor vehicles and parts, non-auto consumer goods, and construction supplies. Reflecting the

sizable decline in manufacturing production, the rate of capacity utilization in manufacturing dropped further below the mid-year high.

In October and November, retail sales in real terms were below the downward revised September level. Real disposable incomes had been reduced by a decrease in total hours worked and by the effects of higher energy prices, and major surveys of consumer attitudes in November indicated that consumer confidence remained at depressed levels. In October, total private housing starts declined substantially further; almost all of the drop reflected additional weakness in starts of multifamily units. Sales of both new and existing houses fell in September and October.

Shipments of nondefense capital goods edged lower in October after changing little, on balance, in previous months. A sizable drop in shipments of aircraft and parts more than offset further increases in the office and computing equipment category. New orders for nondefense capital goods pointed to a considerable softening in business equipment spending in coming months. Nonresidential construction activity fell for a third straight month, and permits and contracts for new construction remained in a downtrend. Manufacturing inventories posted a small increase in October, and the ratio of stocks to sales continued to edge down. At the retail level, non-auto inventories rose moderately after two months of little change; the inventory-to-sales ratio remained within the range that had prevailed for an extended period.

Reflecting a sharper rise in the value of imports than in that of exports, the nominal U.S. merchandise trade deficit widened in October from its average rate in the third quarter. After moderating

somewhat in September, non-oil imports surged in October; the value of oil imports also rose as a sharp increase in prices offset a small decline in volume. Nonagricultural exports registered a sizable increase that more than offset a further drop in exports of agricultural products. Economic growth in the major foreign industrial countries was mixed in the third quarter. Growth remained strong in Western Germany and appeared to have rebounded in France. Some slowing from the rapid rise early in the year had occurred in Japan, while declines in economic activity were recorded in the United Kingdom and Canada. Some moderation in consumer price inflation appeared to be in progress for the major foreign economies, reflecting the nearly completed passthrough to the retail level of the earlier rise in oil prices.

In November, increases in producer prices of finished goods moderated from the rapid pace of previous months; the prices of finished foods again advanced sharply, but declines in the prices of refined petroleum products damped the overall rise in producer prices. Over October and November, producer prices of non-energy, nonfood finished goods increased at about the third-quarter rate, which in turn was somewhat below that in the first half of the year. The pace of consumer inflation also slowed in November, mostly as a result of a smaller rise in energy prices. Excluding food and energy items, consumer prices rose in November at the more moderate pace seen in the previous two months. Average hourly earnings of production or nonsupervisory workers were unchanged on balance over October and November; this represented a

considerable slowing from the increases recorded in earlier months of the year.

At its meeting on November 13, the Committee adopted a directive that called for a slight immediate reduction in the degree of pressure on reserve positions and that also called for giving weight to potential developments that might require some slight further easing during the intermeeting period. The reserve conditions contemplated by the Committee were expected to be consistent with growth of both M2 and M3 at annual rates of about 1 to 2 percent over the period from September through December.

Following the meeting, open market operations were directed toward implementing the slight easing of reserve market conditions sought by the Committee. Subsequently, in early December, in light of further indications of a softening economy and continuing weakness in the monetary aggregates, another slight easing in reserve pressures was carried out. In addition, a number of technical adjustments were made to assumed levels of adjustment plus seasonal borrowing to reflect the declines in seasonal borrowing activity that typically occur late in the year. Adjustment plus seasonal borrowing fell from about $260 million for the reserve maintenance period that ended the day after the November meeting to a little over $100 million for the period completed prior to this meeting. In the early part of the intermeeting period, in the context of continued cautious reserve management by banks and the settlement of the mid-quarter Treasury refunding, the federal funds rate averaged near 7-3/4 percent. Late in the period, after the slight additional easing of policy and as concerns about a year-end squeeze on

the availability of short-term funds abated somewhat, the federal funds rate averaged around 7-1/4 percent. Other market interest rates also declined on balance over the intermeeting period, in some cases substantially, as markets responded to mounting evidence that the economy was slowing significantly and to the easing of monetary policy. Lower interest rates and optimism over a possible peaceful resolution of the Persian Gulf situation contributed to a rise in broad stock market indexes.

The easing of concerns about year-end pressures appeared to have been helped by the announcement by the Board of Governors on December 4, 1990, of the elimination of reserve requirements on nonpersonal time deposits and net Eurocurrency liabilities. These reserve requirements were phased down in two steps, with the second occurring in the reserve maintenance period spanning year-end. This action was not expected to affect underlying pressures on reserves or federal funds rates but was intended to help counter the tightening by depository institutions of credit terms for many types of borrowers by providing those institutions with added incentive to lend to creditworthy borrowers.

In the foreign exchange markets, the dollar fluctuated in value over the intermeeting period in response to changing perceptions regarding the Persian Gulf situation, the release of U.S. employment data for November, and the further easing of U.S. monetary policy. On balance over the period, the trade-weighted value of the dollar rose slightly in terms of the other G-10 currencies. The dollar appreciated more against the yen and sterling; the recent decreases in oil prices

along with expectations of slowing or negative economic growth had sparked large rallies in bond markets in Japan and the United Kingdom. The dollar increased less against the mark, which was generally firm on the basis of continuing strong economic growth in Western Germany and heightened market expectations of further tightening of German monetary policy.

M2 was about unchanged over October and November after growing at a relatively limited pace on balance in earlier months of the year, while M3 declined slightly in both months. The weakness in M2, which persisted despite an earlier decline in opportunity costs, perhaps reflected very weak expansion of nominal income in recent months as well as damped credit growth at depository institutions. From the fourth quarter of 1989 through November, expansion of M2 was estimated to be in the lower half of the Committee's range for the year and M3 near the lower end of its range. Expansion of total domestic nonfinancial debt appeared to have been near the midpoint of its monitoring range.

The staff projection prepared for this meeting pointed to a mild further decline in economic activity over the near term and an upturn before mid-1991. The projection was prepared against the background of persisting uncertainties regarding the prospects for a peaceful resolution of the situation in the Persian Gulf region. The staff assumed that there would be no major further disruption to world oil supplies and that oil prices would drop appreciably further in the first half of next year. The projection took into account the constraints on the supply of credit and an expectation that such constraints would persist to some degree through the year ahead.

Consumer outlays were expected to continue to be damped in the near term by the erosion of real disposable income associated with a reduction in hours worked and the effects of higher energy prices; in light of weak consumer demands, business equipment spending was projected to be sluggish and commercial construction to decline further, given the over-supply of currently available space. Economic growth was expected to resume during the first half of 1991 in association with the effects of the assumed reduction in oil prices on consumer spending and the support provided by further gains in exports. Subsequently, as business sales and orders improved, production and business investment outlays were expected to pick up. The outlook for inflation remained clouded by the uncertainties regarding oil prices but, based on the assumption of a substantial decline in oil prices and some added slack in resource utilization, the staff projected a slower rise in prices and labor costs.

In the Committee's discussion of the economic situation and outlook, members commented that a relatively mild and short recession remained a reasonable expectation, but they emphasized the risks of a more severe and prolonged contraction in economic activity. Generally lean business inventories, favorable conditions for the further growth of exports, and appreciable declines in oil prices from their recent peaks all promised to buoy spending and activity over coming quarters. However, the key to a near-term rebound in the economy was a pickup in consumer spending. Even under the assumption that the Persian Gulf situation would be more settled and oil prices lower, restoration of the degree of confidence needed to induce a substantial upturn in spending

was not assured. The financial difficulties of many borrowers and financial intermediaries, especially banks, could continue to damage confidence as well as to constrain further the availability of credit to many borrowers and contribute to additional declines of asset values in commercial and real estate markets. In general, the economy and financial markets were undergoing a process of adjustment to earlier excesses in leveraging by borrowers and speculative increases in asset prices; while the course and effects of that adjustment were difficult to predict, there clearly had been an increase in the downside risks to the economy as a result. With regard to the outlook for inflation, members saw growing indications that a disinflationary process might be getting underway, and some viewed recent price and wage developments as consistent with an outlook for faster progress in reducing inflation than they had anticipated some months ago.

Regional business developments continued to indicate uneven conditions ranging from modest further growth in some parts of the country, including areas that were benefiting from a relatively strong agricultural sector, to declining activity in an increasing number of regions. Indications of softening economic conditions were widespread, however, even in regions where overall business activity still appeared to be expanding. Business sentiment was negative in much of the nation, and business contacts suggested that it was worsening in many areas. Many state and local governments, notably in relatively depressed areas, were facing severe budgetary problems and were curbing expenditures in response to lagging tax receipts and impaired access to financial markets. Consumer caution was widespread and was evidenced by reports

of generally soft retail sales thus far in the holiday season. Some members commented, however, that while its timing remained uncertain, an improvement in consumer sentiment associated possibly with more settled conditions in the Middle East and an upturn in real disposable income would be likely to generate considerable strengthening in deferred consumer spending, particularly for motor vehicles, and to foster a rebound in overall economic activity. Other comments focused on the possibility that consumer sentiment might well remain bearish and consumer spending restrained for an extended period, perhaps even in the context of favorable developments in the Middle East, as consumers continued to adjust to the adverse wealth effects of weak housing markets, heavy debt loads, concerns about the well publicized difficulties of many financial institutions, and fears about their employment prospects. Weak housing prices affected household spending especially by reducing perceived wealth, but also by eroding the margin of unborrowed equity available to be liquified for spending on other goods and services.

Many of the members stressed that business investment spending was likely to remain relatively weak, particularly the construction of office and other commercial facilities that were overbuilt in many metropolitan areas. To date, the manufacture of capital goods appeared to have held up relatively well in key capital-producing sections of the country, though the output of some types of capital equipment had turned down. Statistical and anecdotal reports suggested that inventories generally remained under tight control, even in relatively depressed

industries and regions, and a pickup in overall demand was therefore likely to lead fairly promptly to stronger production activity.

Members commented that, apart from the key role of consumer spending, current forecasts of a rebound in overall economic activity relied to an important extent on expectations of appreciable further growth in net exports over the next several quarters. The substantial depreciation of the dollar in terms of other key currencies over the past year, especially since mid-1990, would encourage exports and curb imports. Some members noted, however, that economic activity in a number of major trading nations might be somewhat weaker than was anticipated earlier, thereby tending to limit the growth in U.S. exports. That view was reinforced by comments from some domestic exporters who now saw more limited export opportunities in the year ahead, at least to some countries.

Turning to financial developments, members commented that economic recovery would depend to an important degree on the availability of credit. While credit terms and conditions were not projected to tighten appreciably further, the possibility of such a development represented a risk to the economy that could not be ruled out. A major source of financial pressures was the decline in real estate values in many areas and the inability of many heavily indebted borrowers to service their real estate debts. The difficulties in the real estate sector and the related vulnerability of many lending institutions obviously would be aggravated by a prolonged recession. Many business borrowers with less than prime credit ratings continued to report problems in securing financing, even from their usual lenders,

and those problems seemed to be increasing in at least some parts of the country in conjunction with bank efforts to rebuild their capital positions and limit their lending risks in a weak economy. At the same time, there were indications of greater efforts by banks in some areas to increase their loans in order to improve their profits; moreover, many large banks appeared to have made significant progress in adjusting the pricing of their loans to take better account of lending risks; those efforts also could lead to improved profits and to a better availability of credit to many potential borrowers.

The softness in real estate prices was having a pronounced effect on inflationary sentiment, and against the background of reduced pressures on production resources and an extended period of limited monetary growth most of the members believed that substantial progress toward lower inflation was a likely prospect over the next several quarters. Rising unemployment in some areas of the country was clearly reflected in downward adjustments to the wages of some categories of workers. More generally, the rise in broad wage measures appeared to have peaked in an atmosphere of concern about reduced employment opportunities; it was noted in this connection that current unemployment rates probably underestimated actual unemployment, as discouraged potential workers abandoned efforts to secure employment. Members also commented that competitive pressures, including competition from foreign producers, remained strong in retail markets around the country and also in markets for many producer goods.

In the Committee's discussion of policy for the intermeeting period ahead, all of the members indicated that they favored or could accept a directive calling for some slight easing in reserve conditions. Members noted that monetary policy had been eased in several steps over the course of recent weeks; while substantial additional easing might not be needed under prevailing conditions, a limited further move would provide some added insurance in cushioning the economy against the possibility of a deepening recession and an inadequate rebound in the economy without imposing an unwarranted risk of stimulating inflation later. The members favored a cautious approach to further policy moves in light of the appreciable easing in reserve conditions that already had been implemented and the considerable decline that had occurred in market interest rates. The stimulus provided by the recent easing actions had not yet been felt in the economy, and given the lags that were involved, there was some risk of overdoing the easing of policy at some point, with potential inflationary consequences once the economic recovery got underway. Most of the members viewed such a risk as relatively remote and one that could be dealt with, should the need arise, by a future tightening of policy, although it was recognized that moves toward restraint could be difficult. Persisting weakness in the monetary aggregates tended to reinforce the view that policy was not moving in a way that would promote a resurgence in inflation. In evaluating the behavior of the monetary aggregates, members stressed the need for policy to provide adequate liquidity in a period of declining economic activity in order to encourage economic recovery.

Growth of M2 had displayed an uneven pattern but had tended to weaken over the course of the year, especially in recent months. The behavior of M2 was not fully understood, but it appeared to be associated, at least in the past year, with the constrained availability of credit from depository institutions and with lagging income growth. In addition, other factors, such as perceptions of increased risks in holding deposit balances in current financial circumstances, seemed to be affecting monetary expansion. A staff projection prepared for this meeting pointed to a pickup in M2 growth over the months immediately ahead, reflecting in part a projected upturn in the expansion of nominal GNP and the lagged effects of the recent declines in market rates on demands for money balances. Members noted that for the year 1990 as a whole, M2 would increase at a rate within the Committee's range, albeit in the lower half of that range and that M2 growth had now been within the Committee's ranges consistently in recent years. While monetary policy might still be viewed as somewhat restrictive from the standpoint of monetary growth, members cited other indicators such as the decline in interest rates, the shape of the yield curve, and conditions in the commodity and foreign exchange markets as indicative of an adequate provision of liquidity and a basically satisfactory policy in current circumstances. Nonetheless, members stressed the need to maintain an appropriate rate of monetary expansion, and they generally concluded that the behavior of the monetary aggregates would need to be monitored with special care in the period ahead for any indication that their growth might be falling significantly short of current expectations.

During this discussion, members noted the potential interactions between open market policy and a possible, near-term reduction in the discount rate. Most of the Federal Reserve Banks had proposed a reduction of one-half percentage point in the discount rate, and in light of their concerns about the narrowing spread between the discount rate and short-term market rates, the members generally favored Board approval of that reduction to implement an easing of conditions in money markets. Ordinarily, a reduction in the discount rate would show through fully in lower short-term market rates. However, because of their desire to ease reserve conditions only slightly in the near term, the members generally supported a proposal to gear open market operations toward allowing only about one-half of the proposed cut in the discount rate to be reflected immediately in the money market. If the discount rate were not reduced, the Manager for Domestic Operations would execute the slight easing of policy through open market operations alone. With regard to any further adjustment in the degree of reserve pressure later in the intermeeting period, nearly all the members expressed a preference for retaining a bias in the directive toward potential easing, especially given the recessionary tendencies in the economy, current fragilities in the financial system, and the weakness in the monetary aggregates.

At the conclusion of the Committee's discussion, all of the members indicated that they could support a directive that called for some slight further easing in the degree of pressure on reserve positions and that also provided for giving emphasis to potential developments that might require some additional easing during the

intermeeting period. It was recognized that open market operations initially might need to take account of a possible reduction in the discount rate. Subsequent to the initial easing, 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 reserve conditions contemplated by the Committee were expected to be consistent with some pickup in monetary growth, including expansion of M2 and M3 at annual rates of about 4 and 1 percent respectively over the four-month period from November to March.

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 appreciable weakening in economic activity. Total nonfarm payroll employment fell sharply further in November, reflecting widespread job losses that were especially pronounced in manufacturing and construction; the civilian unemployment rate rose to 5.9 percent. Industrial output declined markedly in October and November, in part because of sizable cutbacks in the production of motor vehicles. Retail sales were weak in real terms in October and November; real disposable income has been reduced not only by a decrease in total hours worked but also by the effects of higher energy prices. Advance indicators of business capital spending point to considerable softening in investment in coming months. Residential construction has declined substantially further in recent months. The nominal U.S. merchandise trade deficit widened in October from its average rate in the third quarter as non-oil imports rose more sharply than exports. Increases in consumer prices moderated in November largely as a result of a softening in oil prices. The latest data on labor costs suggest some improvement from earlier trends.

Most interest rates have fallen appreciably since the Committee meeting on November 13. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose slightly on balance over the intermeeting period.

M2 was about unchanged on balance over October and November after several months of relatively limited expansion, while M3 declined slightly in both months. From the fourth quarter of 1989 through November, expansion of M2 was estimated to be in the lower half of the Committee's range for the year and growth of M3 near the lower end 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 ongoing 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 decrease slightly the existing degree of pressure on reserve positions, taking account of a possible change in the discount rate. Depending upon progress toward price stability, trends in economic activity, 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 November through March at annual rates of about 4 and 1 percent, respectively.

Votes for this action: Messrs. Greenspan Corrigan, Angell, Boehne, Boykin, Hoskins, Kelley, LaWare, Mullins, Ms. Seger, and Mr. Stern. Votes against this action: None.

2. Authorization for Domestic Open Market Operations

The Committee approved a temporary increase of $6 billion, to a level of $14 billion, in the limit on changes between Committee meetings in System Account holdings of U.S. government and federal agency securities. The increase amended paragraph 1(a) of the Authorization for Domestic Open Market Operations and was effective for the intermeeting period ending with the close of business on February 6, 1991.

Votes for this action: Messrs. Greenspan Corrigan, Angell, Boehne, Boykin, Hoskins, Kelley, LaWare, Mullins, Ms. Seger, and Mr. Stern. Votes against this action: None.

The Manager for Domestic Operations advised the Committee that the current leeway of $8 billion for changes in System Account holdings was not likely to be sufficient to accommodate the potentially very large need to drain reserves over the intermeeting period ahead. That need would reflect a bulge in available reserves stemming from the elimination of reserve requirements on nonpersonal time deposits and net Eurocurrency liabilities combined with the effects of seasonal reductions in currency in circulation and in required reserves over the intermeeting period.