The Federal Reserve Board

Minutes of the Federal Open Market Committee
Meeting of May 17, 1994

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 17, 1994, at 9:00 a.m.

PRESENT:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Forrestal
Mr. Jordan
Mr. Kelley
Mr. LaWare
Mr. Lindsey
Mr. Parry
Ms. Phillips

Messrs. Hoenig, Keehn, and Melzer, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Ms. Minehan, First Vice President, Federal Reserve Bank of Boston

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Patrikis, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Goodfriend, Lindsey, Promisel, Simpson, Stockton, and Ms. Tschinkel, Associate Economists

Ms. Lovett, Manager for Domestic Operations, System Open Market Account

Mr. Fisher, Manager for Foreign Operations, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Mr. Slifman, Associate Director, Division of Research and Statistics, Board of Governors

Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Johnson, Assistant Director, Division of International Finance

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Bennett, Ms. Browne, Messrs. Davis, Lang, Rolnick, Rosenblum, and Scheld, Senior Vice Presidents, Federal Reserve Banks of New York, Boston, Kansas City, Philadelphia, Minneapolis, Dallas, and Chicago respectively

Mr. Judd and Ms. White, Vice Presidents, Federal Reserve Banks of San Francisco and New York respectively

Messrs. Altig and Coughlin, Assistant Vice Presidents, Federal Reserve Banks of Cleveland and St. Louis respectively

---

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 22, 1994, were approved.

The Manager for Foreign Operations reported on developments in foreign exchange markets and on System open market transactions in foreign currencies during the period March 22, 1994, through May 16, 1994. By unanimous vote, the Committee ratified these transactions.

The Manager for Domestic Operations reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period March 22, 1994, through May 16, 1994. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that economic activity had expanded substantially on balance thus far in 1994. Favorable business expectations and buoyant consumer sentiment in the context of stronger gains in employment appeared to have sustained strong growth in domestic final demand. Broad measures of inflation had remained subdued and labor cost increases had been moderate, though prices of industrial materials had continued to rise.

Nonfarm payroll employment increased sharply in March and April, in part reflecting a rebound in industries affected by earlier severe winter weather; for the first four months of the year, the average monthly rise exceeded the improved pace of the fourth quarter. Further large advances in employment in the March-April period were recorded in the services sector, notably at personnel supply services firms; hiring in construction was strong after earlier weather-related losses; and the number of jobs in manufacturing continued to expand, although at a somewhat slower pace than in previous months. The civilian unemployment rate registered another slight decline in April, to 6.4 percent, and the average workweek of production or nonsupervisory workers remained at an unusually high level.

Industrial production was up appreciably further in April, with increases widespread across sectors. The pace of motor vehicle assemblies slowed, but much of the indicated slowdown reflected the effects of seasonal adjustment, which called for increases at a time when manufacturing operations already were at levels close to capacity. Output of public utilities fell again, as electricity generation dropped with the return to less severe weather patterns. Rates of industrial capacity utilization had risen rapidly in recent months and were at very high levels in many industries--especially in motor vehicles, petroleum refining, lumber, and primary metals.

Retail sales were estimated to have fallen in April after two months of very large increases. Despite the April decline, which was widespread by type of retail outlet, outlays were considerably above the first-quarter average. Sales of new and existing homes posted significant gains in March although they remained below their fourth-quarter averages. Housing starts decreased slightly in April but were well above the depressed winter pace. The third consecutive monthly gain in multifamily starts was more than offset by a decline in single-family starts.

Real business fixed investment continued to increase rapidly in the first quarter, but at a less robust pace than in the fourth quarter of 1993. Outlays for producers durable equipment posted another sizable advance, spending for computing equipment surged again, and purchases of most other types of equipment also continued to trend up. Moreover, business demand for automobiles and trucks remained strong. Outlays for nonresidential structures declined sharply in the first quarter, although construction activity showed some recovery in March after the disruptions associated with severe weather during January and February.

Business inventories declined in March, reversing part of the large run-up in stocks that had occurred in the first two months of the year. For the first quarter as a whole, inventories rose at a slightly slower pace than in the second half of last year. In manufacturing, the accumulation in the first quarter retraced much of the drawdown that had taken place in previous months; the inventory-to-shipments ratio, already at a low level, edged still lower. Wholesale inventories were down on balance over the first quarter, with a large March decline more than retracing increases earlier in the year; the ratio of inventories to sales was well below the range prevailing over the last several years. Retail inventories expanded modestly in the first quarter, and the inventory-to-sales ratio fell slightly.

The nominal deficit on U.S. trade in goods and services was larger on average in January and February than it had been in the fourth quarter. The value of exports in the January-February period was sharply below the unusually strong level in the fourth quarter but was slightly higher than the levels recorded in the first three quarters of 1993. Exports were down in virtually all major trade categories; one important exception was semiconductors, for which exports continued to trend higher. Imports in the two-month period fell by less than exports; nearly all of the decline reflected reduced oil imports. Available indicators for the first quarter pointed to recovery in economic activity at a moderate pace on average in the major foreign industrial countries. Signs of recovery ranged from quite tentative in Japan to relatively well-established in the United Kingdom and Canada.

Indexes of consumer and producer prices had increased slightly thus far in 1994. In April, consumer prices posted their smallest rise since January; food prices were up a bit further, but energy prices retraced their March run-up. Excluding the food and energy components of the index, consumer prices edged up in April, and over the twelve months ending in April these prices increased less than they had over the previous twelve months. Producer prices of finished goods declined a little in April as prices of finished foods and energy moved down; for items other than food and energy, prices were up slightly in April and for the twelve months ending in April. At earlier stages of processing, the index of producer prices of crude materials other than food and energy was substantially above its year-ago level, despite a small drop in April. At the intermediate stage, the prices of some important construction materials had increased sharply although, overall, prices of nonfood, non-energy goods had risen only modestly over the past twelve months.

Increases in labor costs continued to moderate in early 1994. The employment cost index for private industry workers rose more slowly in the first quarter of 1994 than in any quarter of 1993. The slowdown reflected more moderate growth in both wages and salaries and benefit costs. Hourly compensation increased at a slightly slower pace over the twelve months ending in March 1994 than over the previous year. In April, average hourly earnings of production or nonsupervisory workers on nonfarm payrolls increased moderately after having changed little over February and March.

At its meeting on March 22, 1994, the Committee adopted a directive that called for a slight increase in the degree of pressure on reserve positions and that did not include a presumption about the likely direction of any adjustment to policy during the intermeeting period. The directive stated that in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater or slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with moderate growth of M2 and M3 over the first half of 1994.

Immediately after the meeting, open market operations were directed toward implementing the slightly less accommodative degree of reserve pressure sought by the Committee. Subsequently, on April 18, against the background of incoming data suggesting considerable momentum and diminishing slack in the economy and of indications that financial markets were less likely to be destabilized by a further policy action, the degree of accommodation in reserve pressures was reduced a little further. The federal funds rate rose 1/4 percentage point, to 3-1/2 percent, after the initial policy action; following the second policy move, the funds rate went up another 1/4 percentage point and generally remained near 3-3/4 percent. Over the intermeeting period, adjustment plus seasonal borrowing averaged slightly above anticipated levels.

Most market interest rates increased by more than the federal funds rate over the period since the March meeting, with the largest increases occurring at intermediate maturities. Weakness in the dollar as well as the release of data suggesting considerable vigor in economic activity appeared to have contributed to the upward pressure on market rates. The bank prime rate was raised 3/4 percentage point, to 6-3/4 percent, while major indexes of stock prices fell substantially.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined somewhat further on balance over the intermeeting period. The dollar's depreciation occurred despite the implementation of less accommodative policy actions in the United States and monetary easing moves in several key foreign countries. Market concerns about political developments in Japan as well as a worsened outlook for progress toward more open trading relationships and for a more stimulative fiscal policy in that country contributed to downward pressure on the dollar. Against the backdrop of a falling dollar, U.S. authorities conducted intervention operations on April 29 and again on May 4. The latter operations were coupled with a statement by Treasury Secretary Bentsen indicating that intervention was being undertaken in response to recent movements in exchange markets that had gone beyond what could be justified by economic fundamentals and was being conducted in concert with operations by other major countries. Subsequent to these actions, the dollar retraced part of its earlier decline.

Growth of M2 and M3 turned up, on balance, in March and April despite the rising short-term opportunity costs of holding deposits. The strengthening of these aggregates seemed to be related to a reassessment by households of the relative attractiveness of investing in capital market instruments; capital losses sparked substantial net redemptions at bond mutual funds over March and April that were accompanied by a surge in flows to retail money market funds and slower runoffs of small time deposits. For the year through April, M2 expanded at a rate somewhat below the middle of its range for 1994, and M3 at a pace somewhat above the lower end of its range. Total domestic nonfinancial debt continued to expand at a moderate rate over recent months.

The staff forecast prepared for this meeting suggested that economic activity, after rebounding from the disruptions caused by adverse weather conditions earlier in the year, would expand in the second half of 1994 at a rate close to the growth of the economy's potential. Consumer spending, which had outpaced gains in household income for some time, was projected to slow to a growth rate more in line with the expansion of income; with pent-up demands apparently reduced and somewhat higher interest rates exerting a damping effect, much of the slowing was expected to be centered on outlays for durable goods. Business fixed investment would be restrained by the slower growth of business output and the associated moderation of corporate cash flows but would continue to advance at a faster rate than overall economic activity. Homebuilding was projected to remain at a pace that was relatively robust compared with the rate of recent years, though a bit below that of the fourth quarter. The restraint on output growth from federal spending cutbacks and weak export demand was expected to diminish somewhat. In light of limited margins of slack in labor and product markets over the forecast horizon, little or no further reduction in the core rate of inflation was anticipated.

In the Committee's discussion of current and prospective developments, members commented on widespread indications, both statistical and anecdotal, of considerable momentum in the economic expansion. Business activity seemed to be rebounding smartly from the disruptive effects of unusually severe winter weather, and it appeared that the expansion over the first half of the year was likely to be a little stronger than had been expected at the time of the March meeting. A deceleration in activity still seemed to be in train for the second half, but the extent of such a slowing was an important source of uncertainty in the outlook. The members continued to see moderate growth at a rate in line with or slightly above the economy's potential as the most likely prospect, but the overall momentum of the expansion and the still accommodative stance of monetary policy suggested that there was an appreciable risk of faster growth for a period, with consequent implications for greater pressures on resources. At the same time, the members saw relatively few signs of the kinds of imbalances that would pose a significant downside potential for the economy, although some cautioned that the rise in long-term interest rates, recently weaker data on production and sales, and continuing anxiety about job security in an environment of corporate restructuring contributed elements of fragility to what was otherwise a healthy outlook. The near-term prospects for inflation were favorable. Wage and price trends generally remained moderate; the persisting high rate of business investment bode well for further enhancements of productivity; and competitive pressures, including those from imported goods, were restraining efforts by firms to raise prices. The members were concerned, however, that in an environment in which slack in the economy already had been reduced to a fairly low level and could decline further in the quarters ahead, inflation could begin to rise unless monetary policy were adjusted further from its accommodative stance.

In their comments about developments across the nation, members took note of the considerable strength in economic conditions in many parts of the country. However, they also recognized that some parts of the nation were experiencing relatively subdued growth and that economic activity remained depressed in other areas such as Southern California and Hawaii. The strong forward momentum in the economy was most clearly evident in interest-sensitive sectors, including motor vehicles, other durable goods, and housing. The rise in interest rates over the course of recent months was cited by business contacts as a potential source of restraint on interest-sensitive expenditures, but thus far relatively few contacts had reported actual examples of adverse interest-rate effects on spending. While higher rates would constrain aggregate demand going forward, their effects probably would be offset in part by more aggressive lending practices at banks and other institutions. At the same time, reports of industries that were operating at or near capacity limits were becoming more numerous, and capacity constraints were said to be limiting some sales.

With regard to the outlook for key sectors of the economy, consumer expenditures were viewed by many members as likely to be well maintained, particularly for motor vehicles and other consumer durables. Reports from various parts of the country indicated that sales had tended in many areas to exceed retailers' expectations by a considerable margin in recent months. Some members noted, however, that sales had been less ebullient since late winter and cited factors that might work to restrain somewhat the growth of consumer spending. These included high and rising debt levels, declines in household wealth owing to the drop in stock and bond prices, and the effects on consumer confidence of ongoing workforce reductions associated with business restructuring. Higher interest rates also might limit the pace at which pent-up demands would continue to be satisfied. On balance, in the view of a number of members, growth in consumer spending seemed likely to moderate to a pace close to the growth in incomes.

Members expected business fixed investment to continue to expand at a pace substantially above that of the economy as a whole. With production straining capacity limits in a number of industries and firms striving for cost savings and productivity improvements to maintain their competitiveness, real outlays for producers' durable equipment were likely to stay on a strong upward trend despite an anticipated deceleration in business output and the recently increased cost of external capital associated with higher interest rates and lower equity prices. It was noted in this connection that order books at producers of capital equipment had grown considerably. Nonresidential construction appeared to be rebounding from the disruptive effects of unusually severe winter weather conditions; however, the pattern of construction activity across the nation was mixed, with some areas of the country displaying considerable strength in activity and other areas still depressed. The construction of office buildings for the most part remained at very low levels, but anecdotal reports indicated that markets for office space, especially those that had been hard hit in recent years, seemed to be improving considerably in some locales. Business inventories remained quite lean by historical standards, and some reports suggested that efforts to augment stocks had been negated by strong sales. With survey reports indicating that order backlogs had grown and lead times on materials deliveries had lengthened, the possibility was increasing that desired inventory ratios might be adjusted upward and some pickup in inventory investment might get under way, especially in manufacturing where stocks-to-sales ratios recently had fallen to new lows.

Residential construction was indicated to be robust across much of the country, with activity picking up rapidly in the aftermath of the unusually severe winter. The affordability of housing remained high by historical standards, and the appeal of home ownership had been enhanced somewhat by the apparent firming of house prices over the past year. In these circumstances, housing activity had been well sustained, although there were some indications that the higher mortgage rates now prevailing had begun to damp residential investment.

The foreign trade sector was expected to continue to exert some drag on economic growth, but the members saw this as likely to lessen as an anticipated gradual pickup in economic activity among key trading partners bolstered demand for U.S. exports while imports were restrained by a projected moderation in the growth of U.S. domestic demand. In the view of one member, the export sector would tend to sustain and perhaps become an important stimulus to growth in the United States as earlier declines in the dollar, taken in conjunction with technological improvements and higher product quality, enhanced the competitiveness of U.S. exports.

In their discussion of the outlook for prices and wages, the members noted that broad measures of inflation remained subdued and increases in labor costs had been moderate. Nevertheless, they continued to be concerned that inflation could begin to rise if growth in excess of potential were to persist and margins of unutilized production resources were to shrink further, or even disappear. Production already had reached capacity limits in a number of industries, including motor vehicles and steel, and prices of some raw materials and intermediate goods had risen substantially over the past year. Ongoing efforts to expand production capacity through productivity-enhancing investment and the hiring of additional workers were likely to be of some help in meeting growing demands, but an increasing number of contacts were reporting that business firms were taking advantage of opportunities to adjust prices upward. There also were indications of shortages of qualified workers in some labor markets or industries, but to date there were only limited signs of upward wage pressures and these did not seem to signal a near-term emergence of general upward cost pressures on prices. Indeed, even with sales strong, many business contacts were reporting that intense competition, in part from imports, was curbing or negating efforts to raise prices. Firms were continuing to look primarily to improvements in productivity and quality to bolster their profit margins, although there also were reports that price discounting was lessening and that sales promotions were becoming less frequent. Price and wage pressures were most clearly evident and widespread in the construction industry, where resource constraints appeared to be most pronounced.

In the Committee's discussion of monetary policy for the period until the meeting in early July, the members favored prompt further action to remove much of the remaining accommodation in the stance of monetary policy, at least as measured by real short-term interest rates. Many members commented that the expansion was on a solid and self-sustaining basis and appeared to have more underlying strength than they had foreseen earlier. The stimulative effects of an expansionary monetary policy had become increasingly apparent--especially in business purchases of capital equipment and consumer spending on housing, motor vehicles, and other consumer durables. At the same time, the constraints on economic expansion that had been associated with business restructuring activities, widespread efforts to strengthen balance sheets, and other retarding forces had diminished considerably. The financial health of the banking system was greatly improved, and banking institutions had evidenced a growing willingness to make new loans. Moreover, the demand for bank loans, which had been sluggish for several years, now appeared to be on the rise. While a series of small steps earlier this year had already reduced the degree of accommodation in monetary policy and inflation was subdued for the time being, the members were concerned that continued policy accommodation could be expected to lead before long to growing pressures on production resources and to a fresh outbreak of inflation.

In the circumstances, all the members agreed that a further tightening action was needed at this point; and, in order to better assure that the remaining degree of policy accommodation had been largely removed, the adjustment should fully reflect the 1/2 percentage point increase in the discount rate that the Board of Governors was expected to approve later in the day. The actions taken earlier in the year had been modest in size because of concerns that more aggressive steps might generate substantial uncertainty and undue disruptions in financial markets, with adverse consequences for the economy. Even though financial markets remained volatile, speculative sentiment and holdings seemed to have been reduced to a marked extent, and financial markets appeared to be in a much better position to absorb needed policy adjustments. Accordingly, a stronger action probably would not produce an unduly adverse market response and could well have a settling effect on the markets. A number of members cautioned that the Committee could not be sure that today's policy actions, along with those implemented earlier this year, had produced a policy stance that would foster economic growth at a sustainable, non-inflationary pace. Thus, the Committee would have to remain alert to economic and financial developments that might signal the need for further tightening.

In the Committee's discussion of possible intermeeting adjustments to the degree of reserve pressure, all but one of the members indicated a preference for retaining a symmetric directive. Symmetry would be consistent with a judgment that further policy adjustment likely would not be needed during the intermeeting period ahead and, in particular, that additional tightening would not be triggered unless inflation pressures greater than those currently anticipated were to emerge. The adoption of a symmetric directive would not preclude an intermeeting consultation and possible adjustment by the Chairman on behalf of the Committee if such were warranted by intermeeting developments. One member expressed a preference for an asymmetric directive. In his view, a symmetric directive might be mistakenly interpreted both in the United States and abroad as a signal that the Committee believed that policy neutrality definitely had been achieved and that there was no need to allow for the possibility of further tightening.

At the conclusion of the Committee's policy discussion, all the members indicated they could support a directive that called for increasing somewhat the degree of pressure on reserve positions, taking account of a possible increase in the discount rate, and that did not include a presumption about the likely direction of any adjustment to policy during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that slightly greater or slightly lesser reserve restraint might be acceptable during the intermeeting period. According to a staff analysis, the reserve conditions contemplated at this meeting would be consistent with modest growth in M2 and M3 over coming months.

At the conclusion of the meeting, the Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The information reviewed at this meeting suggests that economic activity has expanded substantially on balance thus far in 1994. Nonfarm payroll employment increased sharply in March and April, in part reflecting a rebound in sectors affected by severe winter weather; the civilian unemployment rate fell slightly further in April, to 6.4 percent. Industrial production was up appreciably in April after a strong rise over the previous two quarters. Advance data on retail sales indicate a decline in April, after very large increases in February and March. Housing starts fell slightly in April but remained well above the depressed winter pace. Orders for nondefense capital goods point to a continued strong uptrend in spending on business equipment, while nonresidential building has shown some recovery after severe weather disrupted construction during January and February. The nominal deficit on U.S. trade in goods and services widened on average in January and February from the fourth-quarter rate. Increases in broad indexes of consumer and producer prices remained moderate through April, though prices of industrial materials continued to rise.
>
> Market interest rates have posted large additional increases since the Committee meeting on March 22, 1994. In foreign exchange markets, the trade-weighted value of the dollar

in terms of the other G-10 currencies declined somewhat further on balance over the intermeeting period.

Growth of M2 and M3 picked up on average in March and April; for the year through April, M2 expanded at a rate somewhat below the middle of its range for 1994 and M3 at a pace somewhat above the bottom of its range. Total domestic nonfinancial debt has expanded at a moderate rate in recent months.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 0 to 4 percent respectively, measured from the fourth quarter of 1993 to the fourth quarter of 1994. The Committee anticipated that developments contributing to unusual velocity increases could persist during the year and that money growth within these ranges would be consistent with its broad policy objectives. The monitoring range for growth of total domestic nonfinancial debt was set at 4 to 8 percent for the year. 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 increase somewhat the existing degree of pressure on reserve positions, taking account of a possible increase in the discount rate. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater reserve restraint or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with modest growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Forrestal, Jordan, Kelley, LaWare, Lindsey, Parry, and Ms. Phillips.

Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, July 5-6, 1994.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary