

## Minutes of the Federal Open Market Committee

### Meeting of August 16, 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, August 16, 1994, at 9:00 a.m.

#### **PRESENT:**

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

Messrs. Conrad, Hoenig, Melzer, and Ms. Minehan,  
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

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. Beebe, Goodfriend, Lindsey, Promisel,  
Siegman, 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. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Bennett, Davis, Dewald, Rosenblum, and Vander Wilt, Senior Vice Presidents, Federal Reserve Banks of New York, Kansas City, St. Louis, Dallas, and Chicago respectively

Messrs. McNees, Meyer, and Sniderman, Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, and Cleveland respectively

Ms. Meulendyke, Assistant Vice President, Federal Reserve Bank of New York

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

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Secretary's Note:

Advice had been received that Janet L. Yellen had executed her oath of office as member of the Federal Open Market Committee.

Advice also had been received of the election of Cathy E. Minehan by the boards of directors of the Federal Reserve Banks of Boston, Philadelphia, and Richmond as alternate member of the Federal Open Market Committee for the period ending December 31, 1994, and that she had executed her oath of office; and of the election of William C. Conrad by the boards of directors of the Federal Reserve Banks of Cleveland and Chicago as alternate member of the Federal Open Market Committee for the period ending with the appointment of a president for the Federal Reserve Bank of Chicago or December 31, 1994, whichever comes first, and that he had executed his oath of office.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 5-6, 1994, were approved.

The Manager for Foreign Operations reported on developments in foreign exchange markets during the period since the July meeting. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

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 July 6, 1994, through August 15, 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 the pace of economic expansion, though still substantial, might have slowed somewhat recently. Consumer spending continued to post moderate gains, supported by rising labor income and favorable sentiment. Business outlays for plant and equipment remained on a steep uptrend, but higher interest rates seemed to be having some restraining effect on homebuilding activity. Resource utilization was at elevated levels, with factories operating at relatively high rates and labor markets evidencing very low levels of slack. Increases in broad indexes of consumer and producer prices had remained moderate in recent months, apart from the effects of short-run swings in the volatile food and energy components.

Nonfarm payroll employment continued to advance at a robust pace in July. Hiring in the services industries remained strong, with personnel supply agencies posting another sizable increase. Jobs also were up substantially in retail trade and construction. By contrast, employment in manufacturing was held down by strike activity. The civilian unemployment rate edged up to 6.1 percent in July, little changed from the average for the second quarter.

Industrial production rose moderately in July after a sizable gain in June; a decline in electricity generation from its unusually high weather-related level in June damped the July advance. Manufacturing output was up considerably in July, despite a drop in the production of motor vehicles and parts; outside of motor vehicles, increases were widespread, with a very large rise recorded in the output of durable consumer goods. The overall rate of capacity utilization in manufacturing remained at a high level, with most major industry groups operating at or near capacity.

Growth in consumer spending had slowed in recent months, owing in part to constraints on the supply of motor vehicles. Nominal retail sales edged lower in July after expanding at a slightly reduced pace in the second quarter. Sales at general merchandise and furniture and appliance stores increased further in July, while purchases at apparel outlets were down after large June increases. Sales at automotive dealerships fell appreciably in July after edging lower in the second quarter; these sales declines apparently resulted in part from the inability of manufacturers to produce enough of the most popular models. Housing starts in July retraced part of a large June decline but remained below their elevated rate in the fourth quarter of 1993.

Business fixed investment expanded in the second quarter at about the same brisk pace as in the first quarter but well below the rate recorded in 1993. In the second quarter, a strong recovery in nonresidential construction activity from the weather-related decline of the first quarter offset a marked slowing in business purchases of durable equipment. Much of the slowdown in the growth of outlays for equipment reflected a reduction in the pace of acquisition of office and computing equipment. Other categories of durable equipment, with the exception of aircraft and motor vehicles, continued to show solid increases. Most indicators of business investment activity suggested further large gains in coming months: Orders for nondefense capital goods pointed to a continued strong expansion in spending on business equipment, and permits for nonresidential construction had been rising as well.

Business inventory investment slowed in June after a sharp acceleration in April and May; for the second quarter as a whole, inventories were up substantially but they appeared to have remained broadly in line with sales. In manufacturing, recent inventory buildups had been concentrated in a few industries where orders had been particularly strong. For manufacturing as a whole, the ratio of

stocks to shipments declined from an already low level. At the wholesale level, the accumulation of inventories in the second quarter was largely in durable goods, which were in strong demand; the inventory-to-sales ratio for this sector remained below the range that has prevailed in recent years. A large part of the buildup of retail inventories in the second quarter was in nondurable goods, especially in stocks of general merchandise. For the retail sector as a whole, the inventory-to-sales ratio at the end of June was near the high end of the range observed in recent years.

The nominal deficit on U.S. trade in goods and services widened slightly in May; for April and May combined, the deficit was significantly larger than in the first quarter. Exports of goods and services were about the same in May as in April, with increased shipments of machinery and industrial supplies offset by reduced exports of aircraft and gold. Imports of goods and services were slightly higher in May than in April. Most of the increase was in imports of oil, as a consequence of higher prices, and consumer goods. The economies of all the major foreign industrial countries continued to expand in the second quarter. Growth remained at a healthy pace in the United Kingdom and Canada and appeared to have firmed in continental Europe. In Japan, growth apparently slowed somewhat in the second quarter.

Trends in broad measures of prices and labor costs had shown no change thus far in 1994. In July, the overall index of consumer prices rose at the same pace as in June, despite larger monthly increases in the food and energy components of the index. The jump in energy prices reflected the effects of the earlier run-up in crude oil prices. For the twelve months ended in July, both the overall index and the index excluding food and energy rose by about the same amounts as during the preceding twelve-month period. At the producer level, prices of finished goods were up significantly in July after no change in June; large price increases were recorded for coffee and finished energy goods. Prices of finished goods other than food and energy were unchanged on balance over June and July and registered only a small rise over the twelve months ended in July. At an earlier stage of processing, producer prices of intermediate materials posted another sizable gain in July. These prices had increased at a faster rate thus far this year than in 1993, mirroring a similar pattern in prices of nonfood, non-energy crude materials. The employment cost index for private industry workers rose more rapidly in the second quarter after a sharp slowing in the first quarter, with the acceleration in compensation largely reflecting a pickup in wage and salary growth. The increase in total compensation over the last four quarters was little changed from the advance over the previous four-quarter period.

At its meeting on July 5-6, 1994, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions but that included a bias toward the possible firming of reserve conditions 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 reserve restraint would be acceptable 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 modest growth in M2 and M3 over coming months.

Open market operations during the intermeeting period were directed toward maintaining the existing degree of pressure on reserve positions. Adjustment plus seasonal borrowing rose over the period in accommodation of the usual summer pickup in demands for seasonal credit and averaged near anticipated levels. The federal funds rate remained close to 4-1/4 percent.

Other market interest rates were unchanged to up slightly on balance over the intermeeting period. Rates generally edged lower during the early part of the period as incoming data were viewed by market participants as being consistent with continued moderation in final demands and a reduced

need for any further monetary tightening actions. In early August, however, interest rates began to erase their previous declines, partly in response to the strong employment report, which generated expectations that monetary policy might need to be tightened substantially in the near term. Most major indexes of equity prices were up on balance over the intermeeting period, with second-quarter corporate profits generally better than had been expected.

The trade-weighted value of the dollar in terms of the other G-10 currencies declined early in the intermeeting period but later recouped its losses and ended the period unchanged on balance. The fluctuations in the dollar partly reflected evolving perceptions of the degree to which U.S. authorities were concerned about further weakness in the currency. Over the intermeeting period, the dollar depreciated slightly against the mark but edged higher against the yen.

Both M2 and M3 expanded in July after declining on average over May and June. The growth of M2 in July owed in part to a sizable increase in liquid deposits, but in light of a resumption of run-offs at bond mutual funds it also may have reflected a renewed preference by households for the protection of principal provided by money market mutual funds. The strength in M2 showed through to M3, which also was boosted by funds garnered from wholesale sources to finance a surge in bank credit. For the year through July, M2 and M3 grew at rates slightly above the bottom of their ranges for 1994. Total domestic nonfinancial debt continued to expand at a moderate pace.

The staff forecast prepared for this meeting suggested that the economy was operating close to its long-run capacity and that growth would trend lower over the next several quarters to a rate generally in line with the increase in its potential. Under these circumstances, trends in the core rate of inflation would not deviate significantly from recent experience, but there was a risk that such an outcome might require further monetary policy tightening. Growth in consumer spending was projected to slow in response to smaller gains in employment and income, some reductions in pent-up demands, and the adverse effects on household financial wealth of earlier increases in interest rates and declines in stock market prices. Business fixed investment, while remaining relatively brisk, was expected to decelerate somewhat over the forecast horizon, primarily owing to smaller projected gains in sales, a growing shortfall of corporate cash flow relative to capital outlays, and higher financing costs. Single-family housing construction would continue to be damped by the higher mortgage rates; however, the pace of homebuilding was expected to remain relatively robust compared with the rate of recent years, reflecting still unsatisfied demand for homeownership and the relatively favorable cash-flow affordability of housing, as judged by the standards of the past two decades. The restraint on economic activity exerted by weak export demand was projected to diminish as economic conditions improved abroad, given the competitiveness of U.S. produced goods.

In the Committee's discussion of current and prospective economic developments, members commented that final aggregate demand appeared to have slowed somewhat in recent months but that the expansion still seemed to have considerable underlying momentum. Indeed, available data on the various components of spending taken together might in fact be understating the growth in economic activity; the strength of labor markets and measures of gross domestic income suggested a somewhat stronger economic performance. Sustained expansion, perhaps at a pace broadly in line with or a bit above the economy's long-run growth potential, remained a reasonable expectation, but many members observed that they saw the risks as being on the upside of such a projection in the absence of some further policy tightening. Views varied to some degree with regard to available margins of unemployed resources, but the members agreed that the economy probably was operating very close to, and in the view of some might have reached, its long-run potential. In these circumstances, the members saw appreciable risks of intensifying pressures on resources and higher inflation. Broad measures of wages and prices suggested little change in inflation trends in recent

quarters, but worrisome signs of greater inflation were evident in the prices of materials purchased by business firms and in anecdotal reports of successful efforts by an increasing number of businesses to pass on rising costs by raising prices.

In their comments on business conditions in different parts of the nation, members reported continuing expansion ranging from modest to solid growth in most regions. However, the rise in business activity appeared to have slowed in some areas and business conditions had remained essentially unchanged in a number of others, notably in California. In the course of their review, members pointed to the general strength in labor markets as evidenced, for example, by statistical indications of large and persisting gains in employment and relatively low initial claims for unemployment compensation. These data for the national economy were reinforced by reports of sizable employment increases in numerous industries and parts of the country and associated indications of growing labor shortages in a number of areas and some occupations.

The financial climate remained supportive of sustained economic growth. It was clear that the rise in interest rates since the start of the year had had some restraining effects on interest-sensitive expenditures, notably housing and perhaps to a lesser extent some consumer durables, but to date these effects had not been large. Moreover, surveys and anecdotal reports suggested that banking institutions were becoming increasingly aggressive in their efforts to foster loan growth by easing many terms and standards for lending. In financial markets more generally, risk spreads had remained relatively narrow and both debt and equity markets appeared to be well positioned to provide ample financing for further economic expansion.

In their review of developments in key sectors of the economy, members saw widespread evidence of a well established expansion. Some signs of moderation from the rapid advance in recent quarters had emerged, including statistical and anecdotal indications of somewhat slower growth of consumer spending. Members noted, however, that an apparently significant portion of the recent weakness in sales of motor vehicles appeared to be related to supply shortages that were in the process of being corrected. Consumer confidence remained at a high level and likely reflected, among other factors, the strength in job markets in many parts of the country. Nonetheless, more moderate consumer spending was a reasonable expectation in the context of a low saving rate, increased consumer debt levels, and higher interest rates. One member commented that some pause in the expansion of overall consumer spending would not be unusual after several quarters of robust growth, and another remarked that the rise in household expenditures had been larger than the increase in household cash incomes by an appreciable margin over the past year.

Further marked expansion in business-fixed investment was likely to make a sizable contribution to continuing economic growth. Ongoing strength in orders, including foreign demand, pointed to rapid further growth in expenditures for business equipment over coming months. Some moderation in the growth of such spending appeared likely later in the context of projected slower expansion in sales and the rise in financing costs. The outlook for nonresidential construction, while not ebullient, nonetheless seemed likely to become a more positive factor in fostering further economic growth. Demand for commercial real estate space, including office space, had begun to improve in many areas. Against this background and given the apparent availability of financing for soundly based projects, nonresidential construction activity, while displaying considerable local variation, appeared to be on a moderate uptrend for the nation as a whole.

Prospective developments in foreign trade also were expected to have a positive effect on the expansion of the domestic economy and indeed to offset some of the anticipated slowing in the overall growth of domestic demand. Economic conditions abroad were improving faster than had been anticipated, and this development along with the decline in the foreign exchange value of the

dollar was projected to stimulate faster growth in exports while curbing that of imports over the next several quarters.

Members focused on recent inventory developments, which in the context of some moderation in the growth of final demand had accounted for a considerable portion of the overall expansion in GDP reported for the second quarter. While the rate of inventory accumulation could be expected to slow in the current quarter, the extent of that slowing and its retarding effects on near-term economic growth were uncertain. Partly on the basis of anecdotal reports, the members concluded that much of the inventory buildup in the second quarter was voluntary, thereby reducing the probability of a sharp reversal. Indeed, to the degree that delivery lead times might edge up in various industries as capacity constraints were encountered, stronger efforts to build inventories could emerge, especially against the background of currently low inventory-to-sales ratios. Some business contacts reported that they were planning to add to their inventories over the months ahead. At the same time, ongoing business efforts to maintain relatively lean inventories undoubtedly would tend to limit any broad buildup in inventories.

With regard to the outlook for residential construction, members reported some slowing in single-family housing demand in many parts of the country as homebuyers reacted to the rise in mortgage interest rates. However, single-family homebuilding activity was being maintained at relatively robust levels in some areas and multifamily housing construction was improving in numerous local markets. On balance, the housing sector probably would contribute little, if any, impetus to the expansion but homebuilding was likely to remain well above its earlier depressed levels.

In their assessment of the outlook for inflation, many members focused on the prospects for further growth in output in the context of diminishing margins of unemployed production resources. It was difficult to assess the extent of remaining margins of available resources, in part because of uncertainty about the effects on capacity of ongoing efforts to improve productivity through business restructurings and sharp increases in business investment expenditures. Despite somewhat differing views, the members generally concluded that the economy probably was operating at a level that was quite close to, if not already at, its long-run potential. In the circumstances, many of the members commented that the risks of intensifying inflation clearly were on the upside if the economic expansion did not moderate from its pace in recent quarters. Indications of accelerating cost and price pressures were not yet visible in broad measures of inflation and wages. Those measures, while subject to fluctuations largely associated with swings in food and energy prices, had not displayed any discernible trend over the past several quarters. At the same time, signs of increasing prices and costs at earlier stages of production appeared to be multiplying, including sizable price increases for a wide range of industrial commodities. More generally, members cited a growing number of reports by business firms of rising input costs and of more successful efforts by some firms to raise prices. It also was noted that the decline in the value of the dollar would contribute, directly and indirectly, to some upward pressures on prices. However, business contacts, notably at the retail level, indicated that competition remained intense and made it very difficult to pass on cost increases through higher prices, thereby placing a premium on continued efforts to contain costs through improvements in productivity. From a differing perspective, one member noted that decelerating growth in money measures such as M1, the monetary base, and reserves--which had been expanding rapidly for several years--implied that monetary policy had been moved substantially to curtail any increase in inflation pressures, though more action might still be required.

In the Committee's discussion of policy for the intermeeting period ahead, the members agreed that a prompt further tightening move was needed to provide greater assurance that inflationary pressures in the economy would remain subdued. The members recognized that the Committee's earlier policy actions were exerting some restraining effects and that further lagged effects from those actions

could be expected. Even so, the underlying strength in demand and narrow margins of slack in the economy pointed to a considerable risk of further inflation pressures in the absence of additional policy tightening.

With regard to the size of the policy adjustment, the members were apprised of a disposition on the part of the Board of Governors to approve the 1/2 percentage point increase in the discount rate that was pending at several Federal Reserve Banks. The Committee members endorsed a proposal to allow the effects of such a rise in the discount rate, should it be approved, to be reflected fully in reserve markets. Consideration was given to a lesser adjustment in reserve conditions, but the members concluded that a smaller step was unlikely to be adequate, and on perceiving this, financial markets would quickly build in further monetary tightening, the unknown size and timing of which would add to market uncertainty and volatility. A more decisive policy move might reduce the need for further tightening later, or possibly even avert that need entirely, by moderating or arresting the inflationary momentum in the economy more promptly and by helping to curb inflationary expectations more effectively.

In considering possible adjustments to policy during the period before the next meeting, all the members favored moving to a symmetric intermeeting instruction. Such a directive would be consistent with the members' expectations that a further policy action was not likely to be needed for some time, given the substantial nature of today's policy move. However, a symmetrical directive would not rule out the possibility of a policy move in the event that intermeeting developments differed substantially from expectations.

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 possible adjustments 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 would 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 the pace of economic expansion, though still substantial, may have moderated somewhat recently, while resource utilization has remained at high levels. Nonfarm payroll employment continued to advance at a robust pace in July, but the civilian unemployment rate edged up to 6.1 percent--about the same as the average for the second quarter. Industrial production rose appreciably over June and July. Growth in consumer spending has slowed in recent months, owing in part to constraints on the supply of motor vehicles. Housing starts rose in July. Orders for nondefense capital goods point to a continued strong expansion in spending on business equipment; permits for nonresidential construction have been rising as well. Business inventories registered a large increase in the second quarter, but inventories appeared to have remained broadly in line with sales. The average nominal deficit on U.S. trade in goods and services was larger in April and May than the average for the first quarter. Increases in broad indexes of consumer and producer prices have remained moderate in recent months, apart from the effect of short-run swings in volatile



food and energy components.

Most market interest rates are unchanged to up slightly on balance since the July meeting. The trade-weighted value of the dollar in terms of the other G-10 currencies was unchanged on balance over the inter-meeting period.

M2 and M3 turned up in July following declines on average in both aggregates over May and June; for the year through July, M2 and M3 grew at rates slightly above the bottom of their ranges for 1994. Total domestic nonfinancial debt has continued to expand 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 July reaffirmed the ranges it had established in February 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 maintained at 4 to 8 percent for the year. For 1995, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1994 to the fourth quarter of 1995, of 1 to 5 percent for M2 and 0 to 4 percent for M3. The Committee provisionally set the associated monitoring range for growth of domestic nonfinancial debt at 3 to 7 percent for 1995. 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 would 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, Blinder, Broaddus, Forrestal, Jordan, Kelley, LaWare, Lindsey, and Parry and Ms. Phillips and Yellen.

**Votes against this action:** None.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 27, 1994.

The meeting adjourned at 12:30 p.m.

**Donald L. Kohn**  
**Secretary**

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