The Federal Reserve Board

Minutes of the Federal Open Market Committee
Meeting of September 27, 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, September 27, 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. Hoenig, Melzer, and Moskow 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, Mishkin, 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

Mr. Hooper, Assistant Director, Division of International Finance, Board of Governors

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

Ms. Browne, Messrs. Davis, Dewald, Lang, Rolnick, Rosenblum, and Vander Wilt, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, St. Louis, Philadelphia, Minneapolis, Dallas, and Chicago respectively

Mr. Sniderman, Vice President, Federal Reserve Bank of Cleveland

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

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Secretary's Note: Advice had been received of the election of Michael H. Moskow 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 September 1, 1994, through December 31, 1994, 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 August 16, 1994, were approved.

By unanimous vote, the Committee elected Frederic S. Mishkin as Associate Economist from the Federal Reserve Bank of New York, to serve until the next election at the first meeting of the Committee after December 31, 1994, with the understanding that in the event of his discontinuance of his official connection with the Federal Reserve Bank of New York he would cease to have any official connection with the Federal Open Market Committee.

The Manager for Foreign Operations reported on developments in foreign exchange markets during the period since the August 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 August 16, 1994, through September 26, 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 remained substantial, though it appeared to have moderated slightly in recent months. Final sales, especially of consumer goods, had firmed during the summer months while inventory investment apparently had slowed after a second-quarter surge. Manufacturing activity, bolstered by a pickup in production of motor vehicles, had been rising briskly, and the trend of payroll hiring remained strong. Increases in broad indexes of consumer and producer prices had been somewhat larger in recent months, and prices of materials had remained under considerable upward pressure.

Nonfarm payroll employment advanced appreciably further in August, though at a somewhat less rapid rate than the average pace in earlier months of the year. The slowdown in hiring in August was concentrated in retail trade, where employment was little changed after large gains in the two prior months, and in construction, where it fell slightly. In manufacturing, employment was up considerably after essentially no change in July; while much of the strength was related to a pickup in the production of motor vehicles, hiring was up in a number of other industries as well. The average workweek of production or nonsupervisory workers declined in August from July's relatively high level, but for the two months combined the average hours worked was well above the second-quarter level. Both household employment and the labor force surged in August, and the civilian unemployment rate was unchanged at 6.1 percent.

Industrial production rose sharply in August after sizable gains in previous months. The August advance reflected a large increase in manufacturing output that was partly offset by declines in mining production and electricity generation; much of the strength in manufacturing resulted from a large rise in the output of motor vehicles stemming from unusually rapid retooling for the new model year. Elsewhere in manufacturing, production of office and computing equipment continued to expand briskly, and output of industrial equipment was up significantly. Total utilization of industrial capacity rose further in August from already high levels.

Consumer spending remained on a solid upward trend. Retail sales rose considerably in August after holding steady in July. Sales of goods other than motor vehicles registered sizable increases in both July and August. Sales of motor vehicles, which had been constrained in recent months by shortages of popular domestic models, rebounded in August. Housing starts in July and August averaged slightly less than their second-quarter rate. Single-family starts had leveled off in recent months after declining earlier in the year; multifamily starts, though erratic from month to month, had been drifting higher.

The limited data available for the third quarter suggested that growth of real business fixed investment, though still strong, continued to slow from the very rapid pace of 1993. Shipments of nondefense capital goods declined in July, offsetting much of a large June advance. However, orders for nondefense capital goods were up significantly on balance in June and July, pointing to continued brisk expansion in business spending on durable equipment. Nonresidential construction activity increased further in July, and permits for such construction remained on a mild uptrend.

The growth in business inventories slowed markedly in July after surging in the second quarter. The July deceleration reflected a sizable reduction in retail inventories, principally automotive and general merchandise stocks. For the retail sector as a whole, the inventory-to-sales ratio declined sharply in July to about the middle of the range seen in recent years. At the wholesale level, inventories increased substantially, both in July and over the second quarter, and the overall inventory-to-sales ratio edged up in July toward the middle of the range for this ratio in recent years.

Inventory investment also picked up in manufacturing, where much of the July accumulation represented stocks of materials, supplies, and work-in-progress. The run-up in stocks was accompanied by a drop in factory shipments, and as a result, the inventory-shipments ratio recorded an unusually steep rise.

The nominal deficit on U.S. trade in goods and services widened substantially further in July after a large increase in the second quarter. The value of exports of goods and services slipped in July from a relatively high level in June, while the value of imports in July changed little from June. Economic activity in all of the foreign G-7 industrial countries except Japan expanded rapidly in the second quarter, and available indicators suggested that strong growth continued on average in the third quarter. In Japan, activity contracted in the second quarter, reflecting weakness in consumption and business investment; the limited data available for the third quarter suggested that growth in that country might have resumed.

Consumer prices rose a little faster in July and August than their average pace for the first half of the year. The recent pickup in consumer inflation reflected large increases in energy prices as well as somewhat higher food prices; excluding the food and energy components, consumer price advances had remained moderate. Prices rose briskly at the producer level in July and August as prices of finished energy goods surged and prices of finished foods turned up after declining over the first half of the year. For items other than finished foods and energy, the increase over the July-August period was a little faster than in the first half of the year. Recent data indicated little change in wage trends. Average hourly earnings of production or nonsupervisory workers rose in August at about the rate observed over the previous twelve months.

At its meeting on August 16, 1994, the Committee adopted a directive that called for increasing somewhat the degree of pressure on reserve positions, taking account of a possible rise in the discount rate. The Committee did not include in the directive any presumption about further adjustments to policy during the intermeeting period. Accordingly, 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 or slightly lesser reserve restraint would 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.

Immediately after the conclusion of the August meeting, the Board of Governors approved a 1/2 percentage point increase in the discount rate to a level of 4 percent. The Committee permitted the full amount of the increase to pass through to interest rates in the market for reserves, and the federal funds rate rose about 1/2 percentage point to an average of around 4-3/4 percent. As indicated in an announcement released on the day of the meeting, the Committee did not anticipate that further policy tightening was likely to be needed for a time, given the substantial nature of the policy move. Accordingly, open market operations over the intermeeting period were conducted with a view to maintaining the less accommodative degree of pressure on reserve positions implemented just after the August meeting, and the federal funds rate remained near 4-3/4 percent. In accordance with the usual cresting of seasonal demands for discount credit at this time of the year, adjustment plus seasonal borrowing rose over much of the period but began to edge lower subsequently. Borrowing averaged near anticipated levels.

Most market interest rates were up somewhat on balance since the August meeting. Short-term rates, which had risen prior to the meeting in anticipation of a smaller policy move, increased modestly further after the Federal Reserve tightened and then changed little over the next several weeks. Subsequently, however, these rates began to move higher in response to incoming economic data that were seen as pointing to the potential for greater inflation in the future and hence to further firming in reserve conditions. Long-term yields fell following the policy tightening, but these declines were erased within a few days, and rates later rose noticeably further in response to the incoming data. Most major indexes of equity prices were up on balance over the intermeeting period despite price declines near the end of the period.

The trade-weighted value of the dollar in terms of the other G-10 currencies depreciated somewhat over the intermeeting period. Bearish sentiment toward the dollar in the foreign exchange markets appeared to be influenced importantly by continuing concerns about inflation trends in the United States compared with those in other major industrial countries.

M2 and M3 declined in August after expanding moderately in July, and data available for September pointed to little further change in either aggregate. The August decline in M2 reflected weakness in most of its liquid components that may have been induced to a considerable extent by the rise, which began early this year, in the opportunity costs of holding such accounts. The decline in M3 was associated with a sharp drop in institution-only money funds in response to the increase in market yields, but the weakness in this broader aggregate was limited by the brisk issuance of large-denomination time deposits as banks continued to rely on managed liabilities to fund credit growth. For the year through August, M2 and M3 grew at rates slightly above the lower ends of their respective ranges for 1994. Total domestic nonfinancial debt continued to expand at a moderate rate in recent months.

The staff forecast prepared for this meeting suggested that growth in economic activity would slow appreciably over the next several quarters, dropping briefly below the rate of increase in the economy's potential output. According to a staff analysis, the economy already was operating at its long-run capacity, and the forecast assumed that monetary policy would not accommodate any continuing tendency for aggregate demand to expand at a pace that could foster sustained higher inflation. Growth in consumer expenditures was projected to moderate next year as spending on consumer durables lost some momentum in the context of diminishing pent-up demands, the rise in borrowing costs, and smaller gains in income. After an extended period of very rapid increases, growth in business fixed investment also was expected to slow appreciably, partly reflecting less favorable financial conditions and partly the slower pace of output growth. Homebuilding would be damped by higher financing costs, though activity in this sector was expected to remain well above the depressed levels reached in recent years. With the economy operating close to its long-run potential, no further reduction in the core rate of inflation was anticipated over the forecast horizon. Consumer price inflation was projected to be elevated over the near term--by some pass-through of the ongoing run-up in materials prices and by higher import prices--before settling down again.

In the Committee's discussion of current and prospective economic conditions, members commented on continuing indications of a robust expansion in business activity, with output near maximum sustainable levels. They still viewed significant slowing in the pace of the expansion as a reasonable expectation, though they acknowledged that signs of such slowing currently were limited and in particular that the most recent data indicated a greater probability of somewhat more strength in aggregate demand than had appeared to be developing during the late spring and early summer. The policy tightening actions implemented earlier in the year seemed to have elicited only a mild response thus far in interest-sensitive sectors of the economy. However, much of the retarding effects of those actions, including the recent sizable tightening in August, probably had not yet been felt in the economy. In light of the strength of aggregate demand and lags in the effects of policy, the risks of some rise in inflation rates probably had increased. How large this rise might be or when it might be reversed was very difficult to predict at this point. However, indications of a persisting pickup in inflation would be a matter of considerable concern, and further developments would need to be monitored with special care in light of the Committee's longstanding commitment to containing inflation and moving over time toward price stability to foster the maximum, sustainable performance of the economy.

In their review of developments across the nation, members commented on high levels of business activity in many regions and many of them referred to increasing reports of scarcities of specific types of labor resources. After softening earlier in many areas, business conditions appeared to have strengthened in a number of regions during recent weeks while displaying little change or continued moderate growth elsewhere. Robust expansion in manufacturing activity, especially in the motor vehicle and related industries, was a notable feature of recent business developments. On the financial side, the overall expansion of credit had remained moderate, but many members stressed the ready availability of financing from increasingly aggressive bank lenders. Moreover, despite higher interest rates, capital markets were providing continued support to a wide variety of borrowers. The constraints on the availability of credit and the reluctance of many borrowers to incur new debt, factors that had tended to retard the recovery during its earlier stages, had given way to a financial climate that might even be providing an extra impetus to spending.

With regard to the outlook for activity in key sectors of the economy, consumer spending had been more buoyant than expected over recent months and members saw such spending as likely to be reasonably well maintained. Some moderation in its growth over the quarters ahead seemed likely, however, as pent-up demands increasingly were satisfied and housing-related purchases of consumer durables tended to moderate. Members cited anecdotal evidence of fairly brisk retail sales in many areas recently and associated optimism among retail business contacts. Recent survey results indicated that consumer sentiment remained favorable. Sales of motor vehicles were expected to continue the improvement noted in August as supply shortages were met through increased production.

Business fixed investment was viewed as likely to rise substantially further over the next several quarters, but the rate of growth had been moderating this year and probably would diminish further in conjunction with the projected slowing in overall demand. The expansion in expenditures for business equipment had slowed considerably this year from an extremely rapid rate in 1993 and could be expected to moderate somewhat further. At the same time, nonresidential construction was slowly trending higher as firms facing capacity constraints sought to expand their production facilities.

The prospects for inventory investment remained a key uncertainty in the outlook in that developments in this sector could well have an important bearing on the extent of the anticipated slowing in the expansion of overall economic activity over the next few quarters. The surge in inventory investment in the second quarter clearly was unsustainable, but some members questioned whether the expected cutback in inventory accumulation would be sizable over the near term. Continuing strength in new orders and anecdotal reports did not point to a desire to reduce inventories and suggested that much of the second-quarter buildup probably had been intended. Indeed, in the context of increasing backlogs and lagging deliveries that pointed to growing capacity constraints, many business firms might seek to build "safety stocks" to avoid supply disruptions that would interfere with production schedules. At the same time, the trend toward "just in time" inventory management--even if temporarily arrested as safety stocks were increased--would help to limit a potentially excessive buildup in inventories that would present a threat later to the sustainability of the expansion.

Members cited anecdotal evidence tending to support statistical indications of some weakening in housing markets and they generally anticipated that the rise that had occurred in mortgage interest rates would exert a further damping effect on housing activity over the year ahead. However, against the background of the still relatively favorable affordability of housing and the likelihood of some further pent-up demand, only a moderate drop in overall homebuilding activity seemed likely.

A number of members expressed the view that the external sector was likely to contribute to the expansion of domestic economic activity in light of the depreciation in the value of the dollar and indications of stronger economic growth in foreign industrial nations. However, relatively rapid expansion in foreign economic activity would add to pressures on world commodity prices at least for a time. One member expressed concern about the potential, albeit uncertain, effects on the exchange value of the dollar of developments unrelated to the conduct of monetary policy, such as the ongoing trade negotiations with Japan and forthcoming elections in Germany.

In their discussion of various factors bearing on the outlook for inflation, members noted that some measures of inflation had picked up recently and that many private forecasters anticipated higher inflation in 1995 than in 1994. The worsening of inflation could perhaps be viewed as reflecting increasing capacity constraints in the face of recent growth in overall demand at a pace above the economy's long-run potential. From this perspective, the future path of inflation would depend importantly on the extent to which the expansion in overall activity would in fact abate from an unsustainable pace. Some members expressed particular concern that if above-trend growth did not moderate soon, existing inflationary pressures and inflationary expectations would quickly become more pronounced and inflation would gather momentum. Thus far, however, price pressures remained concentrated in the early stages of production. As evidenced by broad measures of prices and anecdotal information obtained from numerous business contacts, the pass-through of the higher costs of materials to the prices of final goods had been muted in what business executives continued to describe as highly competitive markets. The ability of business firms to hold down price increases in turn reflected to a marked degree their successful efforts to control unit costs through ongoing gains in productivity. Moreover, with profit margins currently at high levels, business firms facing competitive market conditions had some leeway to absorb rising costs. Increasingly tight labor markets in many parts of the country had not resulted in higher overall wage inflation, but members reported some upward pressure on the wages of certain categories of workers in strong demand. One member expressed the view that continued moderation in price and wage increases also might reflect in some measure a shift in price and wage-setting behavior attributable to the credibility of the Committee's anti-inflationary stance in recent years. A number of members commented that the sluggish to moderate growth of a wide variety of money and credit measures provided some assurance that, to date, monetary policy had not laid the basis for a sustained upturn in inflation. Nonetheless, the members concluded that the potential for additional inflation remained substantial and, from a monetary policy standpoint, rendered especially urgent the ongoing assessment of inflation trends.

In the Committee's discussion of policy for the period ahead, most of the members agreed on the desirability of maintaining a steady policy course, at least for the near term. In light of the appreciable tightening of policy approved in August, the members had anticipated that no further policy change was likely to be required for a period, and at this juncture they generally continued to feel that the recent evidence did not warrant an immediate further tightening. Even so, the ongoing inflow of information on the performance of the economy continued to indicate a significant potential for higher inflation down the road, and for many members this suggested that additional monetary restraint could well be needed at some time. A key uncertainty in this regard related to the restraining effects of the policy moves implemented earlier this year; these actions appeared to have exerted less restraint to date than had been anticipated, but appreciable lagged effects from those actions--indeed, perhaps a large part of those effects--could still be expected. At this time, it was extremely difficult to evaluate whether the earlier tightening moves were exerting a lesser effect than usual or it simply was more delayed, or whether the members might have misjudged the underlying strength of the expansion. In the view of many members, the information that would become available during the intermeeting period should provide a firmer basis for judging the course of the economy and the risks of greater inflation. Should incoming information point to a greater likelihood that price pressures would intensify, the Committee would need to act promptly and forcefully to avert an upward ratcheting of inflationary expectations and actual inflation that would be difficult to reverse. Consequently, while views differed with regard to the likely need for some policy tightening over the weeks immediately ahead, the members generally supported a shift from the symmetry in the August directive to asymmetry toward restraint. Some members indicated that they could accept an asymmetric directive, but they expressed misgivings about the use of such an instruction in the directive because they felt it was subject to misunderstanding in financial markets and could add to uncertainty about Committee intentions. One member favored an immediate move to somewhat greater reserve restraint because the available evidence in his view already suggested an upturn in inflationary expectations and the prospect of a significant rise in inflation.

In the course of the Committee's discussion, a number of members commented that the behavior of the monetary and credit aggregates should be taken into account in the evaluation of the current stance of monetary policy. While various money and related measures had for many years proved unreliable to a greater or lesser extent in gauging economic prospects, the weak growth in a wide array of these measures could not be entirely disregarded as a possible indicator of the degree of monetary restraint and argued for caution in implementing any further policy tightening. One member noted, however, that the slow growth in the narrow measures of reserves and money followed an extended period of rapid expansion and their recent weakness might not be indicative of constrained liquidity at this point. Moreover, the ready availability of bank credit and the receptivity of financial markets more generally argued that many borrowers, including small and medium-size businesses, currently had access to ample financing.

At the conclusion of the Committee's discussion, all but one of the members indicated that they could support a directive that called for maintaining the existing degree of pressure on reserve positions and that included a bias toward the possible firming of reserve conditions 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 somewhat greater reserve restraint would be acceptable or slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with modest growth in the broader monetary aggregates over the balance of the year.

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 perhaps moderating slightly in recent months, remains substantial. Nonfarm payroll employment advanced appreciably further in August, and the civilian unemployment rate was unchanged at 6.1 percent. Reflecting strength in motor vehicles, industrial production rose sharply in August after posting sizable gains in other recent months, and capacity utilization moved up further from already high levels. Retail sales were up considerably in August, boosted by a rebound in sales of durable goods, including motor vehicles. Housing starts rose in August but were unchanged from their second-quarter level. Orders for nondefense capital goods point to a continued strong expansion in spending on business equipment; permits for nonresidential construction

remain on a mild uptrend. Inventory accumulation appears to have moderated recently after surging in the second quarter. The nominal deficit on U.S. trade in goods and services widened in July from its second-quarter average. Prices of materials have remained under upward pressure, and increases in broad indexes of consumer and producer prices have been somewhat larger in recent months.

On August 16, 1994, the Board of Governors approved an increase in the discount rate from 3-1/2 to 4 percent, and the Committee agreed that this increase would be allowed to show through completely to interest rates in reserve markets. Most market interest rates are up somewhat on balance since the August meeting. The trade-weighted value of the dollar in terms of the other G-10 currencies depreciated somewhat over the intermeeting period.

M2 and M3 declined in August after expanding moderately in July; for the year through August, 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 maintain the existing degree of pressure on reserve positions. 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, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with modest growth in M2 and M3 over the balance of the year.

Votes for this action: Messrs. Greenspan, McDonough, Blinder, Forrestal, Jordan, Kelley, LaWare, Lindsey, and Parry and Mses. Phillips and Yellen.

Vote against this action: Mr. Broaddus.

Mr. Broaddus dissented because he believed that a prompt move to somewhat greater monetary restraint was needed at this point. In his view, the current stance of monetary policy was overly accommodative in light of the signs of increasing price pressures and rising inflationary expectations that were associated with the continuing strength of the economic expansion and high levels of capacity utilization. In this situation, a delay in implementing some monetary policy tightening would incur a substantial risk of a further increase in inflationary expectations and could make it more costly to achieve the Committee's longer-term anti-inflationary goals.

It was agreed that the next meeting of the Committee would be held on Tuesday, November 15, 1994.

The meeting adjourned at 1:00 p.m.

Donald L. Kohn
Secretary

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