Minutes of the Federal Open Market Committee
Meeting of August 22, 1995

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 22, 1995, at 9:00 a.m.

PRESENT:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Blinder
Mr. Hoenig
Mr. Kelley
Mr. Lindsey
Mr. Melzer
Ms. Minehan
Mr. Moskow
Ms. Phillips
Ms. Yellen

Messrs. Boehne, Jordan, McTeer, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Forrestal, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel

Ms. Brown, Messrs. Davis, Dewald, Hunter, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

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

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

Ms. Johnson, Assistant Director, Division of

International Finance, Board of Governors

Mr. Ramm,[1] Section Chief, Division of Research and Statistics, Board of Governors

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

Ms. Strand, First Vice President, Federal Reserve Bank of Minneapolis

Messrs. Beebe, Goodfriend, Rolnick, Rosenblum, Sniderman, Mses. Tschinkel and White, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, Minneapolis, Dallas, Cleveland, Atlanta, and New York respectively

Mr. Meyer, Vice President, Federal Reserve Bank of Philadelphia

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1. Attended portion of meeting relating to the Committee's economic discussion.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 5-6, 1995, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets and on System foreign currency transactions during the period July 6, 1995, through August 21, 1995. By unanimous vote, the Committee ratified these transactions.

The Manager also 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, 1995, through August 21, 1995. 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 was expanding more rapidly after increasing at a sluggish pace in the second quarter. Consumer spending appeared to be growing at a moderate rate, housing demand seemed to be rebounding sharply, and business investment remained on a solid uptrend. With efforts to adjust inventories still under way, industrial production had changed little in recent months, and employment gains had been modest. After increasing at elevated rates in the early part of the year, consumer and producer prices had risen more slowly in recent months. Advances in labor compensation costs remained subdued.

Nonfarm payroll employment rose further in July after a modest second-quarter gain; the July advance was held down by continuing employment losses in manufacturing that were widespread by industry. Outside of manufacturing, payrolls continued to increase at a relatively slow pace in July; reduced job growth in the services industry reflected smaller increases in employment at business and health service establishments. The civilian unemployment rate rose slightly in July, returning to its second-quarter average of 5.7 percent.

Industrial production edged higher in July, but it was unchanged on balance over the three months ending in July after declining in earlier months. Manufacturing output fell further in July; a sharp contraction in the production of motor vehicles and parts accounted for the entire decline. Within manufacturing, output of business equipment other than motor vehicles continued to advance as additional strong gains were recorded in the production of office and computing equipment. The output of non-auto consumer goods weakened; a cutback in the production of home furnishings offset an increase in the manufacture of appliances. With capacity continuing to expand rapidly, total utilization of industrial capacity dropped somewhat further.

Despite edging down in July, revised data for earlier months suggested that total retail sales had risen appreciably on balance since early spring. The July decline entirely reflected weakness in motor vehicles; elsewhere, spending on furniture and appliances continued to firm, and purchases of other durable goods and of apparel rose sharply. Housing market activity picked up considerably in June, with sales of both new and existing homes increasing significantly. Housing starts were up strongly in July after changing little in previous months.

Shipments of nondefense capital goods, led by surging purchases of computing equipment, continued to grow rapidly in the second quarter. However, business spending for transportation equipment, notably heavy trucks and aircraft, was lackluster. New orders for nondefense capital goods edged lower in the second quarter after rising sharply early this year, although the elevated level of order backlogs pointed to considerable further expansion of spending on business equipment over coming months. Nonresidential construction activity posted a solid gain in the second quarter, and recent data on permits suggested further increases in building activity in coming months.

Business inventory accumulation slowed markedly further in June, and inventory-to-sales ratios for most types of business establishments declined again. In manufacturing, the aggregate inventory-to-sales ratio was only a little above the historical low reached around the end of 1994. In the wholesale sector, the ratio of stocks to sales in June was slightly below the top of the range prevailing over the last year. At the retail level, inventories changed little in June, and the inventory-to-sales ratio for this sector was near the middle of its range for recent years.

The nominal deficit on U.S. trade in goods and services widened in June, with exports declining marginally more than imports. For the second quarter as a whole, the deficit was substantially larger than in the first quarter. Exports were up considerably in the second quarter despite declines in automotive products shipped to Canada and Mexico, but imports rose by even more, with increases widely spread across most major trade categories. In the major foreign industrial countries, economic growth appeared to have ranged from weak to moderate in the second quarter, and the limited available evidence suggested that subdued expansion continued into the third quarter. Economic activity remained particularly weak in Japan. In Europe, expansion apparently was still under way, though somewhat unevenly across countries.

Consumer prices rose more slowly in June and July, with food and energy price movements having little effect on the overall index; price increases for nonfood, non-energy items were somewhat smaller than those seen earlier in the year. Over the twelve-month period ended in July, however, this measure of consumer inflation rose at about the same rate as in the preceding twelve months. Producer prices of finished goods edged lower on balance in June and July, reflecting substantial declines in prices of finished energy goods. Excluding food and energy, producer prices rose by more over the year ended in July than over the preceding year. At earlier stages of production, increases in producer prices had diminished sharply in recent months, perhaps suggesting some abatement of pressures on production capacity and prices. Total hourly compensation for private industry workers increased somewhat more in the second quarter than in the first; however, the rise in compensation costs for the year ended in June was smaller than that for the previous year, primarily reflecting slower growth in costs of benefits. Average hourly earnings grew faster in July than in June; for the year ending in July, earnings rose somewhat more than in the preceding year.

At its meeting on July 5-6, 1995, the Committee adopted a directive that called for some slight easing in the degree of pressure on reserve positions and that included a tilt toward possible further easing 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 might 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 moderate growth in M2 and M3 over coming months.

Immediately after the meeting, open market operations were directed toward implementing the slight easing in the degree of reserve pressure that had been adopted by the Committee. Thereafter, operations were conducted with a view to maintaining this slightly more accommodative reserve posture, and the federal funds rate remained near 5-3/4 percent over the intermeeting interval. Adjustment plus seasonal borrowing averaged somewhat above anticipated levels, largely reflecting heavy adjustment borrowing activity on the August 2 reserve settlement day when demands for excess reserves were unexpectedly large.

Treasury yields declined across the maturity spectrum in response to the announcement of the easing action on July 6; market participants perceived the policy move as an indication of the Federal Reserve's concern regarding the state of the economy and, based on historical precedent, as likely the first in a series of easing steps. Subsequently, however, interest rates rebounded in response to incoming economic data that were seen as suggesting stronger economic performance and reduced chances for further monetary policy easing. On balance, short-term market interest rates posted mixed changes over the intermeeting period, while intermediate- and long-term rates rose appreciably. With unexpectedly favorable corporate earnings reports outweighing the effects of higher interest rates, major indexes of equity prices were up moderately on balance over the period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies appreciated substantially over the intermeeting period. The dollar's gain occurred partly in response to the improving outlook for the U.S. economy and the related rise in long-term interest rates in the United States. Declines in long-term yields in the major European industrial countries probably contributed to a higher value of the dollar in terms of the German mark and most other European currencies. In addition, the dollar appreciated sharply against the Japanese yen, largely in response to actions by Japanese authorities to reduce official interest rates, to encourage capital outflows from Japan, and to make large intervention purchases of dollars during a period when the dollar already was rising against the yen.

M2 and M3 continued to register sizable increases in July and appeared to be expanding considerably further in August. The recent strength of M2 seemed to reflect in part the relatively greater appeal of interest rates on M2 assets in the wake of the declines in market interest rates that had taken place this year, particularly at longer maturities. Robust M3 growth was associated with the continuing requirements of commercial banks for additional wholesale funds needed to meet persisting strong loan growth. For the year through July, M2 expanded at a rate in the upper half of its range for 1995, and M3 grew at a rate above its upwardly revised range. Total domestic nonfinancial debt had been in the upper half of its monitoring range in recent months.

The staff forecast prepared for this meeting suggested that growth in economic activity would pick up from the weak pace of the second quarter. The inventory adjustment process appeared to be well under way, and moderate expansion of final sales would be supported by the favorable wealth and interest-cost effects of the extended rally in the debt and equity markets. In response to improved financial conditions and balance sheets, consumer spending was anticipated to keep pace with the growth of incomes. Homebuilding was expected to strengthen somewhat in response to the earlier decline in mortgage rates and the related improvement in housing affordability. Accompanying slower growth of sales and profits, business investment in new equipment and structures was projected to slow from the very rapid pace of the past few years, although the lower cost of capital and the ready availability of financing would help to sustain appreciable expansion in such investment. Export growth would pick up in response to some expected strengthening in the economies of major trading partners. Considerable uncertainty surrounded the fiscal outlook, but the staff continued to anticipate the greater degree of fiscal restraint that had been projected at the time of the last Committee meeting. In the staff's judgment, the prospects for some further easing of pressure on labor and other resources suggested that price inflation likely would not deviate significantly from recent trends.

In the Committee's discussion of current and prospective economic developments, the members focused on recent indications of some strengthening in the expansion of economic activity after a period of limited growth during the spring. Further growth in final demand was generating an improvement in overall business activity, despite a more rapid adjustment in inventory investment than many had expected. This configuration suggested that the risks of recession or an extended period of subpar growth were now reduced, and sustained expansion at a moderate pace was seen as the most likely course for the economy. Although the risks to the economy now seemed to be more evenly balanced than at the time of the July meeting, they were still sizable in both directions. In particular, uncertainties about federal budget policies and their effects on the economy remained substantial. With respect to prices, members noted that the recent pause in the expansion had eased pressures on resources, and the economy appeared to be in a better position to accommodate moderate growth over the forecast horizon without adding to inflation. Indeed, some members were optimistic that growth of the economy at a pace in line with their expectations would be consistent with modest further decreases in inflation. Others expressed concern, however, that the uncertainties surrounding the outlook for the economy included questions about the persistence of inflationary sentiment and the prospects for further progress toward stable prices over the next several quarters.

Members gave particular attention to the ongoing discussions involving the Congress and the Administration regarding future federal budget deficits. There was a great deal of political support for reducing the federal deficit substantially over the years ahead; indeed, in the view of one member the political dynamics might very well result in larger reductions than many now anticipated. Nonetheless, the actual outcome remained particularly uncertain. From the perspective of its macroeconomic stabilization effects and its implications for monetary policy, enactment of legislation involving substantial fiscal restraint would raise the issue of fiscal drag; however, the latter's impact on the economy would have to be judged in the context of attendant adjustments in market interest rates and, more broadly, in the light of emerging economic conditions. A legislative package containing strong fiscal restraint measures would be expected to ease pressures in debt markets--indeed, enhanced prospects in this regard were probably already contributing to reduced long-term interest rates. On the other hand, a package that included only modest deficit reduction might well lead to upward pressure on interest rates. The continuing uncertainty concerning the size of future budget deficits might be complicated by a delay in passing appropriations legislation in the months ahead, with potentially dislocative effects on many federal government operations. Accordingly, federal budget developments were seen as the major factor likely to bear on the performance of the economy over coming months and quarters, and these developments might well differ considerably from current forecasts.

Members described current business conditions across the nation as ranging from sluggish in some regions to robust in a number of others, with at least some improvement occurring recently in many parts of the country. There were anecdotal reports of strengthening retail sales in numerous areas, with the notable exception of motor vehicles, and of relatively high levels of confidence among consumers and many retailers. Sustained growth in consumer spending was seen as a reasonable expectation for the projection period through 1996. However, diminished pent-up demands and possibly the increasing level of consumer indebtedness would tend to inhibit consumer spending, keeping its growth below that in recent years. These negative factors might be offset to some extent by the wealth effects of the rise in stock market prices and by a higher level of housing activity that should help to support demands for household durables.

Members referred to recent indications, including widespread anecdotal reports, of considerable gains in housing activity after a period of pronounced weakness during the earlier months of the year. Homebuyers were reacting favorably to the declines in rates on fixed-rate mortgages from their highs around the turn of the year. Homebuilders in a number of areas were reported to be optimistic about the outlook for further gains in housing demand, at least for single-family homes. The prospects for multifamily construction seemed less promising; while robust activity characterized such construction in a number of areas, still high vacancy rates and associated overbuilding across much of the nation suggested little, if any, overall impetus from this sector of the housing industry.

The expansion in nonresidential construction was projected to slow from its pace in recent quarters in line with more moderate growth in overall economic activity and reduced pressures on capacity. Even so, with the slowing occurring only gradually as projects under construction were completed, this sector of the economy was expected to remain a positive factor in the overall expansion of economic activity over the next several quarters. The members also anticipated more moderate growth in outlays for producers' durable equipment over the forecast horizon in conjunction with slower growth in final sales. However, current trends pointed to further sizable increases in outlays for office and computing equipment, and such expenditures were expected to buttress still considerable overall growth in spending for business equipment, though at a pace well below the exceptional rate experienced in recent years.

Members commented that the adjustment in business inventories appeared to have progressed a considerable distance but probably was not yet completed for the business sector as a whole. Nonetheless, inventory investment seemed likely to become a more neutral factor in its effects on the overall economy as desired inventory ratios were reached in an increasing number of industries. The recent tendency for order patterns to stabilize was a tentative indication of such a development. In any event, the recent upturn in final sales, apart from its probable effects on desired inventory levels, had allowed a larger-than-expected amount of inventory correction to occur without preventing the economy from regaining at least moderate expansionary momentum.

The external sector of the economy remained subject to particular uncertainty. The members generally viewed some improvement in the country's net export position as a reasonable expectation, but several questioned the potential for much expansion of exports to many of the nation's important trading partners. While recent policy actions in Japan might have diminished concerns about the outlook for overall exports, a number of members indicated that they continued to anticipate fairly limited growth in foreign demands for U.S. goods and services, with the result that the external sector was likely in their view to make a relatively small, if any, contribution to the growth of the domestic economy over the projection period.

Members generally viewed the near-term outlook for inflation as more encouraging than it had appeared to be earlier this year. The pause in the expansion during the spring had eased pressures on resources, as evidenced in part by anecdotal reports of lessening labor shortages in some areas and reduced use of overtime work by some firms, and the higher rate of inflation experienced during the early months of the year seemed unlikely to persist. The members differed somewhat, however, in their assessment of the longer-term outlook for inflation. Some emphasized the reduction that had occurred in inflationary pressures, and with labor costs remaining subdued they felt that economic growth in line with current forecasts should prove compatible with moderating inflation over time. Further, the recent appreciation of the dollar should contribute marginally to a more favorable inflation outcome after some lag. Other members expressed reservations about the prospects for an improved inflation performance over coming quarters. They cited indications of persisting inflationary expectations such as the recent weakness of the bond markets and survey results that pointed to expectations of some rise in inflation from current levels. They also referred to the possibility that favorable labor cost developments would not persist indefinitely in an economy that was operating in the vicinity of its potential.

Turning to monetary policy for the intermeeting period ahead, all the members accepted a proposal to maintain an unchanged degree of pressure in reserve markets and to adopt a directive that was not biased in either direction with regard to potential intermeeting adjustments. For the near term, current trends in economic activity and inflation appeared favorable and likely to remain so with an unchanged policy stance. A steady policy also seemed appropriate pending a clearer assessment of the outlook for fiscal policy. Over the longer term, the members generally believed that consideration would need to be given to an adjustment in the Committee's policy stance, especially if substantial fiscal restraint were to be enacted. The extent to which an adjustment might be needed later in the stance of monetary policy --characterized by some members as slightly to the restrictive side at least in terms of the inflation-adjusted federal funds rate --would have to be assessed in terms of its consistency with the Committee's continuing objectives of fostering price stability and promoting sustained economic growth.

At the conclusion of the Committee's discussion, all the members indicated that they would vote for a directive that called for maintaining the existing degree of pressure on reserve positions. They also favored a directive that did not include a presumption about the likely direction of any 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. The reserve conditions contemplated at this meeting were expected to be consistent with more moderate growth in M2 and M3 over the months ahead.

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 a strengthening in the expansion of economic activity in the current quarter from the weak second-quarter pace. Nonfarm payroll employment increased in June and July after declining in May; the advance was held down by continuing employment losses in manufacturing. The civilian unemployment rate in July was at its second-quarter average of 5.7 percent. Industrial production changed little in recent months after falling earlier while capacity utilization was down somewhat further. Total retail sales have risen appreciably on balance since early spring, but they edged down in July, reflecting weakness in motor vehicles. Housing starts were up sharply in July after changing little in previous months. Orders

for nondefense capital goods still point to considerable further expansion of spending on business equipment over coming months; nonresidential construction has continued to trend appreciably higher. The nominal deficit on U.S. trade in goods and services widened in the second quarter from its average rate in the first quarter. After increasing at elevated rates in the early part of the year, consumer and producer prices have risen more slowly in recent months. Advances in labor compensation costs have remained subdued.

Short-term interest rates have posted mixed changes since the Committee meeting on July 5-6, while intermediate- and long-term rates have risen appreciably. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies appreciated substantially over the intermeeting period, with the gain occurring since the beginning of August.

M2 and M3 continued to register sizable increases in July and appeared to be expanding considerably further in August. For the year through July, M2 expanded at a rate in the upper half of its range for 1995 and M3 grew at a rate above its upwardly revised range. Total domestic nonfinancial debt has grown at a rate in the upper half of its monitoring range 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 range it had established on January 31-February 1 for growth of M2 of 1 to 5 percent, measured from the fourth quarter of 1994 to the fourth quarter of 1995. The Committee also retained the monitoring range of 3 to 7 percent for the year that it had set for growth of total domestic nonfinancial debt. The Committee raised the 1995 range for M3 to 2 to 6 percent as a technical adjustment to take account of changing intermediation patterns. For 1996, the Committee established on a tentative basis the same ranges as in 1995 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1995 to the fourth quarter of 1996. 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, 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 more moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Blinder, Hoenig, Kelley, Lindsey, Melzer, Ms. Minehan, Mr. Moskow, Mses. Phillips and Yellen.

Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 26, 1995.

The meeting adjourned at 12:25 p.m.

Donald L. Kohn

Secretary
