The Federal Reserve Board

Minutes of the Federal Open Market Committee
Meeting of September 26, 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, September 26, 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. Prell, Economist
Mr. Truman, Economist

Messrs. Davis, Dewald, Hunter, Lindsey, Mishkin, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

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

Mr. Madigan, Associate Director, Division of

Monetary Affairs, Board of Governors

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

Mr. Hooper and Ms. Johnson, Assistant Directors, 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. Pianalto, First Vice President, Federal Reserve Bank of Cleveland

Messrs. Lang, Rolnick, Sniderman, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Minneapolis, Cleveland, and Atlanta respectively

Messrs. Cox, Hetzel, Judd, and McNees, Vice Presidents, Federal Reserve Banks of Dallas, Richmond, San Francisco, and Boston respectively

Ms. Meulendyke, Adviser, Federal Reserve Bank of New York

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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 August 22, 1995, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets since the August meeting. There were no transactions in these markets for the System Account during this period, and thus no vote was required of the Committee.

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 August 22, 1995, through September 25, 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 at a moderate rate in the current quarter. Consumer spending appeared to be advancing somewhat further after a sizable gain in the second quarter; housing demand had strengthened in response to earlier reductions in mortgage rates; and business investment remained on a solid uptrend. Although business efforts to pare inventories apparently were still in progress, both production and employment were advancing moderately. After having increased at elevated rates in the early part of the year, consumer and producer prices had risen more slowly in recent months.

Private nonfarm payroll employment increased considerably in August after changing little in July. Much of the rise reflected a pickup in hiring in the services industry, notably in business services. Manufacturing payrolls were up modestly in August; the gain followed substantial declines in the previous four months. Construction employment changed little on balance over July and August, with only small changes being posted each month. The civilian unemployment rate edged down to 5.6 percent in August, remaining in the narrow range that had prevailed since late 1994.

Industrial production jumped in August to a level moderately above its average for the second quarter. Manufacturing output rose sharply, posting its first increase since January; a surge in the production of motor vehicles and parts accounted for some of the advance, but the output of non-automotive consumer goods in August more than reversed a sizable drop in July, and the production of business equipment recorded another robust gain. A steep rise in electricity generation associated with unusually hot weather over much of the country more than offset a decline in mining production. Total utilization of industrial capacity moved higher in August but remained below the average rate for the first quarter.

Retail sales were up slightly on balance over July and August after rising appreciably in the previous two months. Abstracting from the volatile sales of motor vehicles during this period, spending on goods changed little on balance over the two months, as increased outlays for durable goods were offset by flagging purchases of apparel. Spending on services rose in July (latest data available) owing in part to elevated demand for energy-related services during that month's unseasonably warm weather. Housing market activity increased further in July and August. Sales of both new and existing homes in July (latest data) reached their highest levels in more than a year, and housing starts edged up in August after a substantial rise in July.

Shipments of nondefense capital goods fell appreciably in July after having risen rapidly over the first half of the year, and sales of heavy trucks also were down substantially. New orders for nondefense capital goods declined steeply in July: however, the still-large backlog of outstanding orders, coupled with the favorable effects on the user cost of capital of lower interest rates and higher equity prices this year, pointed to further substantial expansion of spending on business equipment over coming months. Nonresidential construction posted another sizable gain in July. Outlays for office, industrial, and institutional structures registered healthy increases, but other commercial building activity was unchanged.

Business inventory accumulation slowed in June and July from a very rapid rate earlier in the year: stockpiling continued at a brisk pace in manufacturing and wholesale trade, but retail stocks were drawn down. In manufacturing, stocks increased in July at about the average rate seen in the second quarter; however, the stocks-to-shipments ratio rose somewhat, reflecting in part a reduction in shipments that might have been exaggerated by difficulties of seasonal adjustment. Wholesale inventories also advanced at about the second-quarter pace, and the inventory-to-sales ratio for this sector moved up to the upper end of its range for recent years. At the retail level, reduced stocks at automotive dealers accounted for much of the July decline in inventories; the ratio of inventories to sales edged lower but remained near the middle of the range for recent years.

The nominal deficit on U.S. trade in goods and services widened slightly in July from its average rate in the second quarter. The value of both exports and imports decreased. For exports, the largest decline was in aircraft and automotive products. The decrease in imports was concentrated in automotive products and gold. Available indicators of economic activity suggested that expansion was continuing in most of the major foreign industrial countries in the third quarter and that the average rate of growth remained near the subdued pace of the first half of the year.

As in other recent months, consumer prices rose more slowly in August than in the early months of the year. Sizable declines in energy prices were a contributing factor, but price increases also had moderated for nonfood, non-energy items; the moderation largely reflected a downturn in automobile finance charges and used-car prices along with smaller increases in airline fares. For the twelve months ending in August, nonfood, non-energy prices rose by the same amount as in the year-earlier period. At the producer level, prices of finished goods edged lower in August after being unchanged in July. Although declines in prices of finished energy goods held down the overall index in both months, prices of finished goods other than food and energy rose more slowly than in the early months of the year; for the twelve months ending in August, nonfood, non-energy prices of finished goods increased slightly more than in the comparable year-earlier period.

At its meeting on August 22, 1995, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions and that did not include a presumption about the likely direction of any adjustments to policy during the intermeeting period. The directive stated that in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater 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 more moderate growth of M2 and M3 over coming months.

Open market operations were directed toward maintaining the existing degree of pressure on reserve positions throughout the intermeeting period. Adjustment plus seasonal borrowing and the federal funds rate generally were in line with expectations, with the funds rate averaging close to 5-3/4 percent. Other market interest rates fell appreciably over much of the period, though these declines were partially reversed near the end of the period. Further evidence of subdued price pressures, indications that the rebound in growth of GDP would be modest, and increasing confidence that significant reductions in federal deficits might be in train contributed to the drop in rates. The lower interest rates, optimistic assessments of corporate earnings, and the brisk pace of merger announcements and share buybacks helped lift major indexes of equity prices to new record levels during the period, though they ended the period below those highs.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined over the intermeeting period. The dollar moved higher over most of the period, partly in response to monetary easing actions in Germany, which were quickly followed by similar steps in other European countries, and in Japan. The policy easing in Japan was accompanied, inter alia, by statements by U.S. and Japanese officials that they would welcome a weaker yen. The dollar reversed course late in the intermeeting period, however, following the announcement of a new Japanese fiscal package and emerging uncertainties about the prospects for European monetary union. On balance over the period, the dollar moved lower against most European currencies while appreciating significantly further against the yen.

After further strong expansion in August, M2 and M3 appeared to be growing at a somewhat more moderate rate in September. The still-brisk demand for M2 assets was associated with the lower market interest rates now prevailing and the related decline in the opportunity costs associated with holding these assets. The relatively robust growth of M3 reflected inflows to institution-only money market funds as well as bank acquisitions of wholesale funds to meet loan demand. For the year through August, M2 expanded at a rate somewhat below the upper end of its range for 1995 and M3 grew at a rate appreciably above its range. Total domestic nonfinancial debt had grown at a rate around the midpoint of its monitoring range in recent months.

The staff forecast prepared for this meeting suggested that growth in economic activity over the forecast horizon would be higher than the weak pace of the second quarter. The process of bringing inventories into better alignment with sales was well under way, and the favorable wealth and interest-cost effects of the extended rally in the debt and equity markets would tend to support moderate expansion of final sales. Consumer spending was expected to grow at a pace generally in line with incomes; the favorable effects on spending of higher prices for financial assets held by households would be offset to a degree in this forecast by less robust labor market conditions and the difficulties that growing numbers of households would encounter in servicing their enlarged debts. Homebuilding was expected to be somewhat stronger in response to the earlier decline in mortgage rates and the related improvement in housing affordability. In anticipation of 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. A great deal of uncertainty surrounded the fiscal outlook, but the staff continued to build a considerable degree of fiscal restraint into its forecast. In the staff's judgment, the prospects for some further easing of pressures 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, members commented that the information available since the August meeting had tended to confirm earlier indications of a pickup in the expansion after a period of sluggish growth during the spring. The economy did not display uniform strength across industries or regions, but it appeared on balance to have considerable and desirable expansionary momentum. Growth at a pace averaging close to, or perhaps slightly below, the economy's potential was viewed as the most likely prospect for the year ahead. The outlook for economic activity remained subject to a variety of uncertainties, including the still unsettled course of the federal budget, and many members saw the risks of a shortfall from expectations as slightly greater than those of significantly faster growth. With regard to inflation, the slower increases in key measures of consumer and producer prices since earlier in the year were a welcome development, and a number of members commented that inflation was likely to remain contained, given likely developments. Many expressed concern, however, that significant further progress toward achieving stable prices might not be made over the next year or two.

In keeping with indicators of nationwide economic performance, anecdotal and other reports on regional activity suggested somewhat uneven business conditions in different parts of the country, but collectively the reports pointed to moderate overall growth. Business activity in most regions had tended to improve or to remain firm during the summer months, though declining growth or very sluggish activity characterized some areas. The level of business confidence generally appeared to have stayed high, but several members indicated that they sensed from their contacts that business expectations were somewhat fragile and vulnerable to adverse developments.

In their discussion of developments in key sectors of the economy, members generally viewed comparatively moderate growth in consumer spending as a likely prospect over the forecast period. After recording sizable gains in late spring, retail sales had been well maintained in recent months, with some strengthening in the motor vehicles sector in August apparently carrying over to September. Favorable factors in the outlook for consumer spending included the increases that had occurred in the value of financial assets and the demand for household appliances and other durables that was expected to be generated by stronger housing activity. On the other hand, overall gains in consumer spending were likely to be restrained by cyclically waning pent-up demands for consumer durables, especially motor vehicles; still widespread concerns about job security associated with ongoing business restructuring and downsizing activities; and higher consumer debt loads.

Housing demand was continuing to respond to more attractive mortgage rates, as evidenced by nationwide data and anecdotal reports from many parts of the country. Increases in construction activity were lagging the improvement in housing demand and had been limited thus far, but considerable strength in homebuilding activity could be expected over the next several months. The extent of further lagged responses to reduced mortgage rates could not be foreseen with any degree of certainty, and in any event housing demand would depend on broad economic developments such as trends in employment and income. Housing activity appeared to have weakened over recent months in one major market where economic conditions were described as relatively sluggish. In many other areas, however, persons in the real estate industry were reported to be optimistic about the outlook for housing.

Business fixed investment remained a strongly positive factor in the economy and was expected to provide further impetus to growth over the next several quarters. The contribution of this sector could be expected to lessen, however, as capital spending was adjusted to expectations of a maturing expansion characterized by the emergence of slower growth in final demand and business profits. In particular, the outsized growth in business spending for equipment did not appear to be sustainable under foreseeable economic conditions.

Diminished growth in inventories still seemed to be retarding the expansion in overall business activity, as evidenced in part by continuing reports of efforts by various business firms to bring their inventories into better balance with sales. Nonetheless, such adjustments now appeared to have been largely completed, or were expected to be completed over the months immediately ahead, so that inventory investment could be expected to have little effect on the course of the economy during 1996. It was noted, however, that projections of inventory behavior were subject to a high degree of uncertainty.

A number of members commented that fiscal policy developments constituted a major uncertainty in the outlook for economic activity. While measures incorporating substantial reductions in spending from current trends were widely expected to be enacted into law, it was not possible to predict the outcome of the continuing debate on the federal budget in the Congress and the Administration. Further complicating any efforts to assess the potential damping influence of prospective fiscal policy were uncertainties regarding the time frame during which the new expenditure and tax measures would be put in place--including the extent to which they would be implemented over the year ahead--and the effects of the new fiscal measures on economic incentives and financial markets. Favorable business and financial market reactions would tend to mitigate, at least for a time, the restraining effects of fiscal measures on aggregate demand. On the other hand, if the deficit reduction measures that eventually were enacted were to fall substantially short of current expectations, there would be adverse repercussions in financial markets and possibly on business confidence.

The nation's trade deficit was expected to diminish somewhat over the next several quarters and in the process to exert less restraint on domestic economic activity. The better trade performance was projected to result from a number of factors, including the improved competitive position of U.S. producers and the lagged effects of earlier declines in the value of the dollar in foreign exchange markets. It also was associated with forecasts of somewhat stronger growth in economic activity abroad than in the United States. While there were continuing anecdotal reports of expanding export markets, some members expressed reservations about the extent to which the economies of major foreign trading partners would strengthen over the forecast period and the related prospects for growth of foreign demand for U.S. goods and services.

Views on the outlook for inflation centered on forecasts of little change or some slight decline in the rate of increase in consumer prices over the year ahead. The appreciable moderation in inflation in recent months had checked the deteriorating trend that seemed to be emerging during the early months of the year, but the members generally believed that recent developments did not point to a significant further decline in inflation. Pressures on producer resources had eased since the early part of the year, but the labor market remained tight and capacity utilization was still above its historical average. In this connection, a few members commented that current forecasts were subject to a range of error that included a risk of some intensification of inflationary pressures.

One uncertainty bearing on the outlook for inflation was the extent to which potentially greater pressures on labor costs would be translated into higher prices. Increases in labor expenses had been held down by markedly reduced advances in the costs of benefits, notably medical benefits. The economies from the latter source might well lessen over coming quarters as the most easily implemented reductions in the costs of providing medical care were achieved. Moreover, the rise in worker compensation had been unusually restrained in recent years in relation to the strong demand for workers, evidently reflecting the effects of worker concerns about job security in a period of business restructurings and downsizings, but continued strength in the demand for labor might be expected to induce more rapid increases in labor compensation over time. Some members commented, however, that the underlying factors affecting employment costs were not likely to change greatly over the forecast period. In addition, the prospect that intense competitive pressures would persist in many markets under projected economic conditions suggested that business firms would continue to find it very difficult to pass on rising costs through higher prices. It also was possible that the rates of capacity utilization and employment associated with a steady rate of inflation had changed in the direction of providing the economy greater leeway to operate at a somewhat higher level without generating more inflation.

In the Committee's discussion of policy for the intermeeting period ahead, all the members supported a proposal to maintain an unchanged degree of pressure on reserve positions. The expansion seemed for now to have a desirable and sustainable momentum that did not call for any change in policy. Furthermore, the outlook remained clouded by the uncertainties stemming from the ongoing federal budget debate. In any event, the Committee would need to remain alert to a broader range of developments that might warrant a policy change at some point. In this connection, several members expressed the opinion that policy might have to be eased eventually in light of the downside risks that they saw in the economy and a current policy stance that they viewed as slightly restrictive. However, the current performance of the economy suggested that the timing of an easing action was not an immediate concern. Other members who preferred an unchanged policy placed more emphasis on current forecasts of little or no progress in reducing inflation from recent levels. They thought it would be premature to ease policy without greater assurance that inflation had been contained in the current cyclical expansion and that prospects for significant further progress toward the long-run objective of price level stability had improved. Indeed, the direction of the next policy move was not clear in the view of some members, and they believed that any easing should await a firm indication that the outlook for economic activity was becoming less favorable or that inflation was decreasing more rapidly than expected.

With regard to possible adjustments to policy during the intermeeting period, the members all endorsed a proposal to retain an intermeeting instruction in the directive that did not incorporate any bias concerning the direction of possible intermeeting policy changes. At this juncture, there was no specific reason to anticipate developments that would call for an adjustment to policy during the weeks ahead. While a change in policy certainly could not be ruled out, the reasons for the change likely would involve sensitive issues that would warrant Committee consultation regardless of the intermeeting instruction.

At the conclusion of the Committee's discussion, all the members indicated a preference for a directive that called for maintaining the existing degree of pressure on reserve positions and 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 growth in M2 and M3 over the balance of the year at a pace near that experienced in recent months.

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

> The information reviewed at this meeting suggests that economic activity is expanding at a moderate rate in the current quarter. Nonfarm payroll employment increased considerably in August after essentially no growth in July; the civilian unemployment rate edged down to 5.6 percent in August. Industrial production posted a large increase in August to a level moderately above the average of the second quarter. Total nominal retail sales rose slightly on balance over July and August after registering appreciable gains in the prior two months. Housing starts were up a little in August after increasing sharply in July. Orders for nondefense capital goods have softened but still point to substantial expansion of spending on business equipment over coming months; nonresidential construction has been strong of late. The nominal deficit on U.S. trade in goods and services widened slightly in July from its average rate in the second quarter. After increasing at elevated rates in the early part of the year, consumer and producer prices have risen more slowly in recent months.
>
> Market interest rates have fallen somewhat since the Committee meeting on August 22. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies has declined over the intermeeting period, with most of the decline occurring over the past several days.
>
> M2 and M3 continued to register sizable increases in August but growth of those aggregates appears to have moderated somewhat in September. For the year through August, M2 expanded at a rate somewhat below the upper end of its range for 1995 and M3 grew at a rate appreciably above its range. Total domestic nonfinancial debt has grown at a rate around the midpoint 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 growth in M2 and M3 over the balance of the year near the pace of recent 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.

Discussion of Proposed Legislation

At this meeting, the Committee discussed a bill, titled the "Economic Growth and Price Stability Act of 1995," that recently had been introduced in the United States Senate. The bill would make price stability the primary long-run policy goal of the Federal Reserve and require the Federal Reserve to establish a numerical definition of price stability and to implement a policy that would effectively promote such stability over time. It would repeal the Full Employment and Balanced Growth Act of 1978 (the "Humphrey-Hawkins Act") and certain related provisions in the Employment Act of 1946 and the Congressional Budget Act of 1974. The Federal Reserve had not yet been asked its views of the bill, but testimony was likely at some point and a preliminary discussion would help to identify important issues.

The members had not had time to review the bill in detail or to consider fully all its implications. Nonetheless, their initial reaction was favorable in regard to the overall thrust of the bill's monetary policy provisions. These would make clear that price stability was the primary long-run objective of monetary policy and would restructure the monetary policy reporting requirements to permit the Congress to carry out its oversight responsibilities more effectively. Many members felt that in the context of seeking and maintaining price stability, monetary policy should have the flexibility to react to short-run fluctuations in output and employment, and they believed the bill would be improved if its intent in this regard were clarified. A few members expressed strong reservations about the part of the bill that would delete the employment objectives set forth in the Employment Act of 1946.

It was agreed that the next meeting of the Committee would be held on Wednesday. November 15, 1995.

The meeting adjourned at 1:20 p.m.

Donald L. Kohn
Secretary

Return to top

Last update: May 4, 2007