Minutes of the Federal Open Market Committee

Meeting of December 17, 1996

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, December 17, 1996, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Jordan
Mr. Kelley
Mr. Lindsey
Mr. McTeer
Mr. Meyer
Ms. Phillips
Ms. Rivlin
Mr. Stern
Ms. Yellen

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Messrs. Hoenig, Melzer, and Ms. Minehan, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Boston 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
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Lang, Lindsey, Mishkin, Promisel, Rolnick, Rosenblum, Siegman, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, 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. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

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

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Beebe, Davis, Eisenbeis, and Goodfriend, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Kansas City, Atlanta, and Richmond respectively

Messrs. Gavin, Kos, and Rosengren, Vice Presidents, Federal Reserve Banks of St. Louis, New York, and Boston respectively

Mr. Evans, Assistant Vice President, Federal Reserve Bank of Chicago

---

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 13, 1996, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets since the meeting on November 13, 1996. There were no transactions in foreign currencies for 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 from November 13, 1996, through December 16, 1996. By unanimous vote, the Committee ratified these transactions.

The Committee members discussed certain changes in the procedures for conducting domestic open market operations that the Manager of the System Open Market Account had proposed for implementation at the beginning of 1997. The changes included advancing the normal time for initiating daily operations by one hour to between 10:30 a.m. and 10:45 a.m. Moving to the earlier time would place Desk operations closer to the period during the day when the financing market was most active and thus in a position to accommodate a larger volume of System transactions when necessary. As at present, the Manager might choose to undertake Desk operations at other times during the day when special circumstances dictate. The Manager also indicated that the normal time for domestic operations might be moved to an even earlier hour after expedited procedures were developed for assembling the necessary statistical information on a timely basis for such operations. In the interest of making information about System operations available more promptly to market participants and the broader public, the Desk also would begin at the start of 1997 to announce the par amount of its market transactions shortly after the completion of the operations. With respect to purchases of Treasury coupon securities for System account, the Desk had adopted about one year ago the practice of making such purchases in separate maturity tranches but might at its option in the future spread such purchases over a number of weeks rather than over the course of several days. This more flexible timing would allow the Desk to inject reserves into the banking system through outright operations as the need arose without waiting for that need to accumulate to particularly high levels.

Return to top

All the members who commented endorsed the changes, with several noting that they were appropriate responses to evolving market circumstances. Because the new procedures did not involve any alterations in the Committee's current directives, authorizations, or rules, a formal vote was not required.

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

The information reviewed at this meeting suggested that economic activity had continued to expand at a moderate pace in recent months. Consumer spending had rebounded from its summer lull, but housing demand was somewhat weaker on balance and the growth of business spending on durable equipment had slowed from a very rapid pace. Although inventory investment had picked up, stocks in most sectors had remained well aligned with sales. Both industrial production and employment had recorded sizable advances. Increases in labor compensation had trended up this year, and consumer price inflation also had picked up, but the faster rise in overall consumer prices owed entirely to larger increases in food and energy prices.

Private-sector demand for labor remained solid in November. Private nonfarm payroll employment increased appreciably further in November after an October surge, and the average workweek of private production or nonsupervisory workers retraced more than half of its October decline. Service industries recorded another large gain in employment despite a sharp drop in payrolls at help-supply firms, and the number of jobs in retail trade expanded further in November after a steep rise in October. In the goods-producing sector, employment in construction and manufacturing rose moderately. The civilian unemployment rate increased slightly, to 5.4 percent, in November.

Industrial production rose sharply in November after a small October decline. A rebound in motor vehicle assemblies from the disruptive effects of work stoppages accounted for much of the increase in production in November, but output from utilities also surged in response to unusually cool weather. The production of nondurable consumer goods and business equipment other than motor vehicles also was up significantly in November while the manufacture of consumer durables and defense and space equipment decreased further. Reflecting the strong advance in production, the utilization of total industrial capacity picked up considerably in November.

Consumer spending increased appreciably on balance in recent months after a lackluster performance in the summer. Total retail sales fell in November but nonetheless were considerably above their average in the third quarter. The November decline reflected weakness in auto sales; retail spending on other items, notably durable goods, rose significantly further. Spending on services picked up in October (latest data) following a relatively weak third quarter. Housing starts rebounded in November after declining in September and October. Single-family starts in November were a little below the average pace of previous months in the year while multifamily starts surged to a level not seen since late 1990. By contrast, sales of both new and existing homes dropped again in October (latest data).

Return to top

Growth of business fixed investment appeared to have slowed to a moderate pace in the fourth quarter after a sharp rise in the previous quarter. Shipments of nondefense capital goods fell in October, reversing a sizable September gain; however, recent data on orders pointed to further increases in business spending for equipment, especially for communications equipment where shipments already were at a high level. Business investment in transportation equipment evidently weakened, as sales of heavy trucks remained sluggish and production shortfalls held back fleet sales of light vehicles. By contrast, nonresidential construction continued to expand at a solid rate in October, with building activity particularly strong in the office, other commercial, institutional, and industrial categories.

Business inventory investment picked up sharply in October from the slow September pace, but total stocks remained at a low level in relation to sales. Most of the October increase occurred at the wholesale level; inventories of farm products turned up sharply after months of sizable drawdowns, and petroleum stocks were built up from unseasonably low levels. Despite the October rise, the ratio of wholesale inventories to shipments remained at the lower end of its range over recent years. In manufacturing, stocks increased at a pace in line with shipments, and the aggregate inventory-shipments ratio stayed at a very low level. Retail inventories were up moderately in October. The inventory-sales ratio for the sector was unchanged and remained in the middle of its range over recent years.

The nominal deficit on U.S. trade in goods and services was somewhat larger in September than in August; exports decreased slightly in September while imports were little changed. For the third quarter, the deficit widened substantially from its rate in the second quarter as exports fell and imports rose moderately. Nearly all of the decline in exports reflected lower sales of aircraft and gold. Increases in imports were widespread but they were largely offset by declines in imports of gold and semiconductors. Economic growth picked up in most of the major foreign industrial countries in the third quarter, but available indicators generally suggested some slowing of growth in the fourth quarter. In Japan, by contrast, economic activity had been sluggish in the third quarter but appeared to have picked up more recently.

Consumer price inflation in October and November was lifted slightly by sizable advances in energy prices and, to a lesser degree, increases in food prices; however, consumer prices for items other than food and energy rose modestly during the two months. The rise in core consumer prices over the twelve months ended in November was somewhat smaller than it had been over the previous twelve months, although the total index registered a bigger advance as a result of larger increases in food and energy prices. At the producer level, prices of finished energy goods rose sharply in October and November while prices of finished foods advanced less rapidly. Excluding food and energy, prices of finished goods edged lower on balance over October and November, and in the twelve months ended in November, these prices rose substantially less than in the previous twelve months. Average hourly earnings of production and nonsupervisory workers were up considerably in November after edging down in October. The twelve-month rise in this index was somewhat larger than the advance over the previous twelve months.

At its meeting on November 13, 1996, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions but that included a bias toward the possible firming of reserve conditions during the intermeeting period. The directive stated that in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with moderate growth of M2 and relatively strong expansion of M3 over coming months.

Open market operations during the intermeeting period were directed toward maintaining the existing degree of pressure on reserve positions. However, the federal funds rate tended to average a little above the level expected with an unchanged policy stance in apparent response to scattered operating problems and occasional unexpectedly large clearing needs at banks. Other short-term interest rates registered small mixed changes since the November 13 meeting; Treasury bill rates drifted lower, partly because of heightened demands for safety and liquidity as asset markets became more volatile during the period, while year-end pressures boosted rates on private instruments with maturities in early 1997. At longer maturities, yields drifted lower over most of the intermeeting period in response to incoming data that suggested economic growth would remain moderate and inflation subdued, but they rebounded late in the period in response to the release of firmer economic data and growing concerns regarding the sustainability of current domestic asset prices. Despite these concerns, most major indexes of equity prices advanced further on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose slightly over the intermeeting period. The dollar rose even more against the German mark and the French franc amid increased market apprehension that the European Monetary Union's common currency, the euro, will not be as strong a currency as the mark. The dollar also might have been boosted by statements by French and German officials that suggested the dollar was undervalued against their currencies.

Return to top

Expansion of the broad monetary aggregates was relatively strong in November. Growth of M2 picked up, reflecting a sharp increase in demand deposits and smaller runoffs in other checkable deposits. Inflows to retail money market funds remained substantial. Expansion of M3 moderated somewhat from its brisk pace in October as growth in business demands for credit slowed and banks reduced their reliance on large time deposits and other managed liability components. For the year through November, M2 was estimated to have grown at a rate in the upper half of the Committee's annual range, and M3 at a rate a little above the top of its range. Total domestic nonfinancial debt expanded moderately on balance over recent months and remained in the middle portion of its range.

The staff forecast prepared for this meeting suggested that the expansion would be sustained at a pace close to the economy's estimated growth potential. Consumer spending was projected to increase at a rate generally in line with the anticipated rise in disposable income; the favorable effects on household wealth of the advance that had occurred in stock prices and the ample availability of credit for most borrowers were expected to balance the damping effects of continuing consumer concerns about the adequacy of their savings, the security of their jobs, and the extent of their debt burdens. Homebuilding was forecast to decline somewhat but to stabilize at a relatively high level in the context of continued income growth and the generally favorable cash-flow affordability of home ownership. Business spending on equipment and structures was projected to expand less rapidly in light of some anticipated slowing in the growth of sales and profits. Fiscal policy and the external sector were expected to continue to exert small restraining influences on economic activity over the projection period. Consumer price inflation, excluding the relatively volatile food and energy components of the price index, was forecast to rise slightly over 1997 and 1998 in the context of anticipated high resource use and an accompanying appreciable pickup in the growth of labor compensation that would be augmented by the legislated rise in the federal minimum wage. Somewhat larger increases would have been projected in consumer price inflation in the absence of anticipated technical measurement changes to the index.

In the Committee's discussion of current and prospective developments, members commented that the information received during the relatively short interval since the previous meeting had not materially altered either their assessment that the economy was performing quite favorably or their forecasts of further growth at a pace averaging near the economy's potential. The economy currently displayed fairly solid underpinnings, with few imbalances of the kind that historically had tended to create problems. Against the background of generally supportive financial conditions and a high degree of consumer and business confidence, further economic growth was thought likely to be sustained by appreciable increases in consumer spending and business investment. The overall pace of the expansion was expected to be restrained to an extent, however, by declining federal government outlays for goods and services and ongoing weakness in net exports.

Despite the prospects for moderate economic growth, members observed that the risks on inflation still seemed to be tilted toward some rise over time. Measures of core inflation had displayed little trend and even some decline over the past year. However, wage increases had moved higher over that period, a development suggesting the possibility that labor markets might be tighter than could be sustained over the long term. At some point accelerating labor compensation costs, were they to continue, likely would spill over into higher inflation. Such an outcome remained subject to a great deal of uncertainty, however, in light of the relatively benign behavior in recent years of both wages and prices in comparison with historical experience at prevailing levels of resource utilization.

▲ Return to top

In the Committee's discussion of developments in major sectors of the economy bearing on the outlook for business activity, members noted that consumer spending had picked up as expected after a lull during the summer months. Survey data and anecdotal reports suggested that consumer confidence was currently high, and there were widespread indications of robust retail sales during the early weeks of the holiday season, though holiday sales were always difficult to read at this stage. Thus far, however, sales of motor vehicles had not strengthened to the extent that was anticipated after full production was restored following a work stoppage at a major manufacturer. Members cited a number of factors--the rise in consumer debt burdens, tightening consumer credit standards, continued worker concerns about job security, and the satisfaction of earlier pent-up demands--that were tending to inhibit the growth in consumer spending and perhaps helped to explain why the sharp increases in stock market wealth had not been accompanied by stronger growth in such spending. The behavior of the stock market injected an additional note of uncertainty into the forecast for consumer spending and the economy more generally. The rise over recent years had been extraordinary and had brought market valuations to fairly high levels relative to earnings and dividends. In these circumstances, the members recognized the need to monitor with special care price movements in the stock market and asset markets more generally for their implications for consumer and other spending. On balance, favorable employment and income conditions seemed likely to foster a level of consumer spending that would provide key support for sustained economic expansion.

The members anticipated smaller though still sizable gains in business fixed investment over the year ahead. Slowing growth in profit levels and cash flows was likely to retard spending for many types of business equipment, but favorable prices, advancing technology, and readily available financing probably would continue to foster rapid expansion in office, computing, and communications equipment. The outlook for nonresidential construction remained uneven across the country, but such construction seemed likely to edge higher on balance over the next several quarters. Members noted in this regard that the construction of office buildings had strengthened in a number of urban areas. Business inventories currently seemed on the whole to be at desired and sustainable levels in relation to sales. In the circumstances, inventory accumulation was projected to remain moderate and, barring unexpected surges or declines in final sales, was not likely to be a significant factor affecting the course of the economy.

The recent information on residential construction was mixed. Weakness in late summer and early fall evidently reflected the effects of earlier increases in mortgage interest rates, but some measures of housing activity in November indicated unexpected strength. In addition, reports from around the country pointed to uneven conditions ranging from further strength to some emerging weakness in regional housing markets. On balance, the statistical and anecdotal information was interpreted, by some members at least, as consistent with a tendency for housing activity to stabilize. In this view, a level of housing construction somewhat below the peak reached earlier in 1996 was likely to be sustained, buoyed in part by the recent decline in mortgage interest rates and the continuing rise in consumer incomes and favorable consumer sentiment.

A modest degree of fiscal restraint seemed likely over the next two fiscal years. Some members expressed optimism with regard to the prospects for an agreement between the President and the Congress that would provide a basis for reaching a balanced budget by the year 2002. Such an agreement would need to include controversial constraints on the growth of entitlements, but its achievement would have favorable effects on financial markets and on business and consumer sentiment more generally, thereby tending to offset at least in part any direct effects of reduced federal spending on aggregate demand.

Members anticipated that the external sector of the economy would continue to exert some restraint on domestic economic activity, though perhaps to a lesser extent than over the past year. In particular, the growth of U.S. exports was expected to accelerate somewhat in association with some strengthening on average in the economies of the nation's key trading partners. The economic recovery in Mexico from its earlier financial crisis was already providing a considerable boost to exports from some parts of the United States.

Return to top

Inflation had remained subdued, but the members continued to view the risks as tilted toward increases in the future. Labor compensation costs clearly were rising at a faster pace in the context of persistently tight labor markets, and an upturn in core price inflation seemed quite possible at some point in the absence of some easing of pressures in labor markets. However, the members recognized that the increase in wage inflation had been significantly less than would have been anticipated on the basis of historical relationships with labor market conditions, and price performance also had been more favorable than those relationships would have suggested. In the circumstances, there was a good deal of uncertainty regarding the outlook for inflation, including the potential degree of utilization in labor markets, the associated pressures on labor costs, and the ability of firms to pass higher labor costs into prices in markets that generally continued to be described as highly competitive. With the economy operating in the neighborhood of its sustainable potential, relatively minor differences in overall economic growth could have a significant effect over time on whether inflation would tend to trend up or down.

In the Committee's discussion of policy for the intermeeting period ahead, all the members supported a proposal to maintain an unchanged policy stance while also retaining a bias toward restraint in the directive. An unchanged policy was warranted by the quite satisfactory performance of the economy and inflation and the uncertainties surrounding the outlook. Thus, while the longer-term risks might point toward rising inflation, there were reasonable prospects that inflation would remain contained, and any pickup in inflation, should it occur, was likely to be limited at least for a time. In the circumstances, the members concluded that watchful waiting remained the prudent course for policy as they continued to assess ongoing developments. Because the risks of waiting did not appear to be substantial at this juncture, anticipatory tightening was not yet called for.

In the Committee's discussion of possible adjustments to policy during the intermeeting period, members agreed that the retention of an asymmetric directive toward tightening was consistent with their view that the risks remained biased toward higher inflation. Accordingly, while they were not suggesting that policy should be especially quick to react to incoming information over the intermeeting period, they did view the next policy move as more likely to be in the direction of some firming than toward easing. In this connection, some members emphasized that it would be especially important for the Committee to act promptly to counter any tendency for price inflation to rise and for higher inflation expectations to become embedded in financial markets and economic decision-making more generally.

Return to top

At the conclusion of the Committee's discussion, all the members indicated that they supported a directive that called for maintaining the existing degree of pressure on reserve positions and that retained 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 and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with relatively strong expansion in M2 and M3 over coming 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 has continued to expand at a moderate pace. Private nonfarm payroll employment increased appreciably further in November, although the civilian unemployment rate edged up to 5.4 percent. Industrial production rose sharply in November, in part because of a rebound in motor vehicle assemblies that had been depressed earlier by work stoppages. Consumer spending has posted appreciable gains over recent months after a summer lull. Housing starts rebounded in November after declining in September and October. Business fixed investment appears to be growing moderately after a sharp rise in the third quarter. The nominal deficit on U.S. trade in goods and services widened substantially in the third quarter from its rate in the second quarter. Increases in labor compensation have trended up this year, and consumer price inflation also has picked up owing to larger increases in food and energy prices.
>
> Short-term market interest rates have registered mixed changes since the Committee meeting on November 13, 1996, while long-term yields have risen slightly. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies has risen slightly over the intermeeting period.
>
> Growth of M2 picked up in November, while expansion of M3 moderated somewhat from its brisk pace in October. For the year through November, M2 is estimated to have grown at a rate in the upper half of the Committee's annual range, and M3 at a rate a little above the top of its range. Total domestic nonfinancial debt has expanded moderately on balance over recent months and has remained in the middle portion of its range.
>
> 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 January for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1995 to the fourth quarter of 1996. The monitoring range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1997, the Committee agreed on a tentative basis to set the same ranges as in 1996 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1996 to the fourth quarter of 1997. 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 relatively strong expansion in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Boehne, Jordan, Kelley, Lindsey, McTeer, Meyer, Mses. Phillips, Rivlin, Mr. Stern, and Ms. Yellen.

Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, February 4-5, 1997.

The meeting adjourned at 12:40 p.m.

Donald L. Kohn
Secretary

Return to top
