The Federal Reserve Board

Minutes of the Federal Open Market Committee

Meeting of March 25, 1997

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, March 25, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Meyer
Mr. Moskow
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

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

Messrs. Eisenbeis, Goodfriend, Hunter, Lindsey, Mishkin, Siegman, 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

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

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

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

Governors

Messrs. Dewald, Hakkio, Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, Philadelphia, Minneapolis, and Dallas respectively

Messrs. Altig, Bentley, Judd, and Kopcke, Vice Presidents, Federal Reserve Banks of Cleveland, New York, San Francisco, and Boston respectively

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By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on February 4-5, 1997, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no System open market transactions in foreign currencies during the period since the meeting on February 4-5, 1997, 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 U.S. government securities and federal agency obligations during the period February 5, 1997 through March 24, 1997. By unanimous vote, the Committee ratified these transactions.

The Manager advised the Committee that he continued to anticipate a pattern of reserve needs that might require another unusually large addition to the System's outright holdings of U.S. government securities during the relatively long intermeeting period ahead. The limit on increases in outright holdings between meetings had been raised to $12 billion at the February meeting, and the Manager requested that the higher limit be retained for the upcoming period. By unanimous vote, the Committee amended paragraph 1(a) of the Authorization for Domestic Open Market Operations to raise the limit on intermeeting changes in such holdings from $8 billion to $12 billion for the period ending with the close of business on the date of the next meeting, May 20, 1997.

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

The information reviewed at this meeting suggested that the economy had continued to expand at a relatively robust pace in early 1997 after strengthening markedly in the fourth quarter of 1996. Much of the more recent growth reflected further acceleration in consumer spending, but business capital expenditures, housing activity, and an upturn in inventory investment also had contributed to the recent increase in total expenditures. By contrast, available data pointed to a sharp drop in net exports after a surge in the fourth quarter. To meet the strong aggregate demand, employment had recorded another large advance in early 1997 and industrial production had risen somewhat further. The underlying trend in consumer price inflation had remained subdued, but the increase in average hourly earnings had continued to edge higher early this year.

Private nonfarm payroll employment rose substantially further in January and February. The gains continued to be led by sizable advances in the services and trade industries. Employment in construction increased considerably over the two months, largely because of unseasonably warm weather across much of the country in February that led to an earlier-than-usual pickup in building activity. Aggregate hours of private production workers, which were also affected by changing weather conditions, were up appreciably on balance over the two months, and the average workweek increased considerably, reaching a new recent high in February. The civilian unemployment rate, at 5.3 percent in February, was unchanged from its average level in the second half of 1996.

Industrial production rose appreciably in February after declining slightly in January. The February advance resulted from a surge in the manufacturing of durable goods that was only partly offset by a plunge in the output of utilities associated with unseasonably mild weather in that month. The utilization of total manufacturing capacity was unchanged on balance over the two months at a level slightly above its long-term average.

Consumer spending strengthened considerably further in early 1997 after registering a sizable increase over the fourth quarter. Nominal retail sales rose sharply in January and February. The gains over the two months were concentrated in sales of durable goods, including motor vehicles and building materials. Spending on services rose strongly in January (latest data) but may have moderated in February when milder-than-normal weather held down heating costs. Recent surveys indicated that consumer confidence had risen to the highest levels in many years.

Housing construction rose sharply in February after two months of relatively depressed activity. On balance, various indicators of housing activity had been mixed over the past several months and did not suggest any clear trend in spending for new housing.

Recent trends in orders and shipments pointed to a sizable further rise in outlays for producers' durable equipment in early 1997, largely reflecting continued rapid growth in purchases of computers and some further increase in spending for communications equipment. Expenditures for other types of equipment remained little changed. In the nonresidential construction sector, trends in contracts suggested some further spending gains in most market segments after strong advances in the fourth quarter. Manufacturing and trade inventories rose somewhat in January, roughly offsetting small declines over the previous two months. With sales and shipments rising rapidly in January, inventory-sales ratios for a wide range of industries dropped further from already low levels.

The nominal deficit on U.S. trade in goods and services widened substantially in January from its temporarily depressed rate in the fourth quarter. Nearly all the deterioration in the trade balance reflected a sharp rise in imports; that increase was largely the result of a rebound in automotive shipments from Canada, which had been temporarily reduced by a strike. Recent information on economic activity in the G-7 countries suggested continued expansion at a moderate rate on average in early 1997, but rates of expansion had continued to diverge among those economies. Growth in output still appeared to be relatively strong in Japan, Canada, and the United Kingdom, while much weaker economic performances were indicated for the major continental European countries. The economies of the major developing countries in Latin America and eastern Asia apparently continued to expand in late 1996.

Data for January and February were consistent with the continuation of a subdued trend in underlying price inflation. Overall consumer price inflation moderated somewhat over the two months from its pace in the fourth quarter; smaller increases in energy prices were an important factor in the slowdown, but prices of consumer items other than food and energy also advanced at a slower rate over the first two months of the year. For the twelve months ending in February, consumer prices excluding food and energy rose somewhat less than they had over the preceding twelve months; a development contributing importantly to the deceleration was a smaller rise in non-oil import prices associated with the appreciation of the dollar. At the producer level, overall prices of finished goods declined somewhat in January and February, reflecting an appreciable drop in the food and energy components. For the twelve months ending in February, the increase in the overall index of finished goods prices was little changed from that over the preceding twelve months, but excluding food and energy prices, which had registered sizable advances in 1996, the rise was considerably smaller over the latest twelve-month period. At early stages of processing, however, some producer prices had moved up in recent months. Average hourly earnings of production and nonsupervisory workers posted small further increases in January and February but were up appreciably more over the twelve months ending in February than over the preceding twelve months.

At its meeting on February 4-5, 1997, the Committee issued a directive that called for maintaining the existing degree of pressure on reserve positions. The directive included a bias toward the possible firming of reserve conditions, reflecting a consensus among the members that the risks were clearly in the direction of an upward trend in inflation and that the next policy move was more likely to be toward some tightening than toward easing. In this regard, 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 some slowing of the growth of M2 and M3 over coming months.

Over the period since the February meeting, open market operations were directed toward maintaining the existing degree of pressure on reserve positions. Federal funds continued to trade mainly at rates close to the 5-1/4 percent level expected with an unchanged policy stance, though the rate did at times fall below that level in conjunction with unanticipated shortfalls in demands for excess reserves. Most other market interest rates rose somewhat over the intermeeting period in apparent response to indications of stronger-than-expected economic activity, perceptions that the Federal Reserve had become more concerned about a possible buildup in inflation pressures, and perhaps disappointment over the prospects for legislation to reduce the federal budget deficit. In these circumstances, expectations built that monetary policy would be tightened. The rise in most market interest rates was accompanied by slight declines in a number of major indexes of stock market prices, although stock prices in some industries posted more pronounced declines.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose further over the intermeeting period. The dollar's appreciation appeared to reflect spreading perceptions of a relatively strong U.S. expansion and associated increases in U.S. interest rates compared to those abroad. The dollar's rise was most pronounced against the continental European currencies.

Growth of M2 moderated somewhat in January and February from a brisk pace in late 1996, while expansion of M3 remained rapid in both months. Data for the first part of March suggested diminished growth of both aggregates. The appreciable further expansion of these broad aggregates thus far this year probably continued to reflect elevated income growth, and the relative strength of M3 was associated to an important extent with heavy bank reliance on large-denomination time deposits to fund robust asset growth. M3 also continued to be boosted by the rapid growth of money market mutual funds. The expansion of total domestic nonfinancial debt appeared to have slowed in the early part of the year in conjunction with reduced borrowing by both federal and state governments, which were drawing down cash balances.

The staff forecast prepared for this meeting suggested that the expansion in economic activity would slow in coming quarters to a pace somewhat above that of the economy's estimated potential and would moderate a bit further in 1998. Growth in consumer spending was expected to decline appreciably from its recent pace but to remain fairly brisk over the quarters ahead, supported by further projected gains in employment and incomes. Expansion in business spending on equipment and structures also was projected to moderate, but to a still relatively high rate, in association with smaller increases in sales and profits. Housing construction was forecast to drift lower over coming quarters, partly reflecting the rise that already had occurred in mortgage interest rates. The staff continued to anticipate that fiscal policy and the external sector would exert mildly restraining effects on economic activity over the year ahead. With resource utilization high and labor compensation rising, core consumer price inflation was forecast to increase slightly over the year ahead.

In the Committee's discussion of current and prospective economic developments, members referred to the widespread statistical and anecdotal evidence that the surprising strength in economic activity over the closing months of 1996 was persisting in 1997. Some observed that it was difficult to detect signs of weakness or imbalances in domestic sectors of the economy. While the members believed that some slowing in the expansion was inevitable, they felt that substantial uncertainty surrounded the timing and extent of such slowing in the quarters ahead. Continued growth near, or even somewhat below, the recent pace would raise resource utilization rates further from their already high levels. Although labor markets already were tight, inflation had remained relatively subdued, and there were no signs in price data that it was picking up. However, the risks of a rise in inflation down the road had increased appreciably as a result of the strength of aggregate demand and the increase in pressures on resources that likely would accompany it absent a firming in financial conditions.

In their discussion of the outlook for spending in key sectors of the economy, members emphasized the strength of consumer spending in recent months. They noted that anecdotal reports from numerous parts of the country and surveys indicating very high levels of consumer confidence tended to confirm statistical evidence of an ebullient consumer sector. While the recent surge in consumer demand probably was supported mainly by rapid growth in employment and labor income, it seemed possible that consumers also were responding increasingly to the run-up in household net worth stemming from the earlier buoyant performance of the stock market. The effects of rising financial wealth on consumer spending were difficult to isolate, and they were undoubtedly restrained by efforts to accumulate savings for future expenditures such as college expenses and retirement. Moreover, the constraints on spending imposed by the high debt burdens of many households tended to exert at least a partly offsetting influence on overall consumer spending. On balance, however, the members believed that the consumer sector was likely to provide major ongoing support to the expansion, though the increases in consumer spending probably would diminish in the context of more restrained growth in jobs and incomes. A number of members expressed the view, however, that the risks to such a forecast were in the direction of more robust consumer spending.

Business fixed investment, which had remained on a steep uptrend for an extended period, also was expected to provide continuing though moderating stimulus to the overall economic expansion. Growth in expenditures for business equipment was forecast to decline from the extraordinary pace of recent years, despite continuing brisk demand for computers and communications equipment. With regard to the outlook for nonresidential building activity, anecdotal reports from several regions pointed to a further pickup in commercial construction associated with declining vacancy rates, rising property values and rents, and readily available financing. Indeed, reports from a few areas indicated the emergence of speculative building activity. On the other hand, in some regions, signs of slowing nonresidential construction were reported.

Housing construction activity had fluctuated in recent months, largely in response to changing weather conditions, but such construction appeared to be little changed on balance. Recent anecdotal reports pointed to improving housing markets in several regions and to some easing in a few. Looking ahead, the members generally anticipated that housing activity would be maintained at a relatively high level, perhaps slightly below that prevailing on average in recent quarters, barring unanticipated developments in the broader economy or in financial markets. While the rise that had occurred in mortgage interest rates was a somewhat inhibiting influence on the prospects for housing, favorable factors noted during the meeting included the ongoing effects of the large gains in stock market wealth, sizable increases in employment and incomes, and a still relatively favorable cash-flow affordability of home ownership.

The persisting efforts by business firms to economize on their inventories had reduced the latter to quite low levels in relation to sales. In the circumstances, current inventory levels were viewed as an upside risk to the expansion that could be triggered by unexpected strength in final demand. Absent an upside surprise in demand, inventories might be expected to remain a slightly positive factor in the economic outlook; and if growth in final demand were to moderate more than anticipated, the currently lean inventories could be viewed as minimizing the risks of accumulating weakness in the near term.

The outlook for fiscal policy remained one of modest restraint; on the basis of existing legislation, reductions were anticipated in constant-dollar purchases of goods and services by the federal government in fiscal years 1997 and 1998. A key element in the potential impact of fiscal policy was the uncertain outcome of the current effort to eliminate the federal deficit over time. Although success in that effort probably would have little effect on the government's budget position over the next few years, it likely would have some beneficial repercussions on business and consumer confidence and possibly also on financial markets. Financial markets would be especially positively affected by an agreement to reduce significantly the growth of entitlements, which would damp government spending and deficits over the longer run.

The unwinding in the early months of 1997 of special factors that had boosted net exports in the fourth quarter of 1996 was offsetting some of the effects on production of the persisting strength in domestic demand. Beyond the near term, the appreciated value of the dollar was expected to hold down net exports, restraining overall demand and growth. Some members observed in this regard that the deterioration in net exports might be substantial. While such an outcome would help to moderate inflationary pressures on domestic resources in coming quarters, it also would exacerbate the longer-term problem of very large foreign trade and current account deficits.

In their review of developments bearing on the outlook for inflation, members commented that the risks now seemed to be tilted more clearly toward higher inflation. They acknowledged that it was difficult to find indications of rising inflation in broad measures of consumer or GDP-related prices; indeed, such measures still could be viewed as consistent with a slightly declining trend in price inflation. Even so, prospects for a substantial period of economic expansion at a rate that exceeded the estimated growth of potential had generated increasing concerns of rising inflationary pressures in an economy that already was operating at high levels of resource utilization. Members observed in this regard that while there was little evidence of growing demand pressures on capital resources, the tightness in labor markets appeared to be intensifying. Indications of such a development included not only widespread anecdotal reports but a variety of data such as initial claims, insured unemployment, and help-wanted advertising. The rise in labor force participation to a high percentage of the working age population had helped to keep the unemployment rate from falling, but the unexpected increase in participation was itself suggesting tight conditions that were inducing marginal workers into the job market.

The data on worker compensation were somewhat mixed, but they suggested some acceleration on balance. Members noted that the damping effects of some temporary factors on labor costs could well begin to wane soon, if they had not already begun to do so. These included the possibility that job security concerns might be diminishing after an extended period of rapid job growth and low unemployment. The downward trend in medical cost increases might be in the process of shifting to a flat, if not a rising, gradient according to informed observers. Moreover, as the rise in labor force participation depleted the pool of available workers, less productive workers would tend to be hired, with adverse effects on productivity and costs. The members recognized that even though aggregate demand pressures seemed to be pressing increasingly on available producer resources, it was not possible to forecast with confidence when the period of favorable price behavior would end. Even so, it was clear that inflationary developments in the economy had become a matter of more urgent concern for monetary policy.

In light of this concern, in the Committee's discussion of policy for the intermeeting period ahead, the members supported or could accept a proposal to adjust policy toward a slightly less accommodative stance and to move to symmetry in the directive. They noted that continued relatively rapid growth of economic activity in the first quarter suggested greater persisting strength in demand than they had anticipated. With resource use already at high levels, further rapid growth risked greater pressures on resources and rising inflation. Although inflation remained remarkably subdued and any increase in inflationary pressures likely would tend to emerge only slowly, the strength in demand had developed against the backdrop of financial conditions that, broadly considered, were not substantially different from those now prevailing. In this situation, they saw a clear need for a preemptive policy action that would head off any pickup of inflation, and it was noted that a shift to a tighter policy stance would seem to pose little risk to the expansion. Indeed, by countering any tendency for inflation to rise and for higher inflation expectations to become embedded in financial markets and economic decision-making more generally, such action would help head off a more abrupt economic slowing, or even a downturn, and thereby would help sustain the expansion and preserve the firm labor markets and their associated benefits.

A few members argued that a more substantial tightening was needed at this juncture to provide a better calibrated response to the persisting strength of the economy and the related risk of intensifying inflationary pressures. In their view, a more vigorous action would lessen the need for tightening in the future and also would foster a financial setting that would be more conducive to sustained expansion. Other members acknowledged that a smaller policy move would have less effect in curbing inflationary pressures, but they felt that a cautious approach to policy was desirable at a time when the outlook for economic activity and inflation remained subject to substantial uncertainties. Some noted that a shift in policy direction, as the Committee was about to undertake, often can have exaggerated effects in financial markets, making it difficult to judge how much additional restraint, if any, might be needed.

In their discussion of possible adjustments to policy during the intermeeting period, a majority of the members favored a symmetric directive. While additional policy tightening might be needed at some point, it did not appear very likely that developments during the intermeeting period would require a further policy move. Some added that inflation remained quiescent and the near-term onset of an appreciable slowing of the expansion to a rate more in line with the economy's potential could not be ruled out. Accordingly, they felt that the directive should not establish a presumption about further near-term policy tightening. Other members believed that growth of the economy was not likely to slow enough to alleviate excess demands for resources and that additional tightening would be needed sooner rather than later to moderate inflationary pressures and prolong the expansion. In their view, the outlook called for vigilance and the maintenance of an asymmetric directive with a bias toward tightening, but they could accept a symmetric directive with careful monitoring of new developments for any signs of the need for prompt action.

At the conclusion of the Committee's discussion, all the members indicated that they supported or could accept a directive that called for a slight increase in the degree of pressure on reserve positions and that did not include a presumption about 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 reserve restraint or slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the expansion of 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 relatively strong economic growth has continued in the first quarter. Private nonfarm payroll employment increased substantially further in January and February, and the civilian unemployment rate, at 5.3 percent in February, was unchanged from its

level in the second half of 1996. Industrial production rose moderately on balance in January and February. Nominal retail sales increased sharply further over January and February after a considerable advance in the fourth quarter. Housing activity strengthened markedly over January and February, though much of the rise probably related to unusually favorable weather. Recent data on orders and contracts point to a further sizable gain in business fixed investment in the first quarter. The nominal deficit on U.S. trade in goods and services widened substantially in January from its temporarily depressed rate in the fourth quarter. Underlying price inflation has remained subdued.

Most market interest rates have risen somewhat since the Committee meeting on February 4-5, 1997. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies increased further over the intermeeting period.

Growth of M2 moderated somewhat in January and February from a brisk pace over the fourth quarter while the expansion of M3 remained relatively robust; data for the first part of March pointed to diminished growth in both aggregates. Total domestic nonfinancial debt has expanded moderately on balance over 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 February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to increase slightly 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 might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin.

Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 20, 1997.

The meeting adjourned at 12:20 p.m.

Donald L. Kohn
Secretary

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