Minutes of the Federal Open Market Committee

Meeting of August 19, 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, August 19, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
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. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Cecchetti, Goodfriend, Eisenbeis, Lindsey, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

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

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

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

Messrs. Lang, Rolnick, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Minneapolis, Dallas, and Cleveland respectively

Messrs. Gavin, Kahn, and Ms. Perelmuter, Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, and New York respectively

Ms. Little and Mr. Sullivan, Assistant Vice Presidents, Federal Reserve Banks of Boston and Chicago respectively

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By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 1-2, 1997, were approved.

By unanimous vote, the Committee elected Mr. Stephen G. Cecchetti of the Federal Reserve Bank of New York as Associate Economist to serve until the election of his successor at the first meeting of the Committee after December 31, 1997. It was understood that in the event of the discontinuance of his official connection with the Federal Reserve Bank of New York, he would cease to have any official connection with the Federal Open Market Committee.

The Manager of the System Open Market Account reported on developments in foreign exchange markets since the meeting in early July. There were no System open market transactions in foreign currencies 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 July 2, 1997, through August 18, 1997. By unanimous vote, the Committee ratified these transactions.

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 economic activity was expanding moderately. Growth in consumer spending had picked up after having slowed sharply in early spring, business purchases of durable equipment were still on a strong upward trend, and housing demand seemed to have been well maintained. The overall rise in production had been held down recently by supply disruptions in the motor vehicles industry, but employment had continued to expand at a strong pace and the unemployment rate was at a low level. Increases in labor compensation had remained moderate even though labor markets were tight, and price inflation was still subdued.

Private nonfarm payroll employment rose sharply in July after a June increase that was below the average for earlier months of the year. The step-up in job growth in July reflected substantially larger job gains in business services, retail trade, and the finance, insurance, and real estate industries. A small decline in manufacturing jobs roughly offset slightly higher employment in construction. The civilian unemployment rate, at 4.8 percent in July, matched its low for the current economic expansion.

Industrial production increased relatively slowly in July after having advanced at a fairly brisk pace over the first half of the year. The July slowdown reflected a temporary drop in motor vehicle assemblies partly associated with work stoppages at a major automotive manufacturer. Outside the motor vehicles sector, the output of business equipment and consumer durable goods rose strongly while the production of consumer nondurables weakened further. Factory capacity increased a little more than production in July, and the utilization of total manufacturing capacity slipped to its lowest level since last autumn.

Retail sales rose briskly in June and July after having changed little over the preceding three months. Sales at automotive dealers rebounded in June and July following substantial weakness in earlier months, and expenditures at nondurable goods stores also strengthened. By contrast, sales at non-automotive durable goods outlets were unchanged over June and July. The pickup in consumer spending occurred against a backdrop of further strong gains in incomes and household net worth. In addition, credit was readily available to most consumers, although lenders continued to tighten terms for marginal borrowers. Total private housing starts were unchanged in July after having rebounded in June from a May decline. Data on home sales in recent months continued to suggest that demand for single-family housing was still relatively buoyant.

Real business fixed investment increased substantially further in the second quarter, reflecting a broad-based surge in spending on producers' durable equipment. Real outlays for office and computing equipment continued to grow rapidly as prices of personal computers and networking equipment remained on a steep downtrend. Spending for communications equipment grew at a slower pace in the second quarter, but recent orders for such equipment pointed to larger increases in the current quarter. Nonresidential construction activity was sluggish in the second quarter. While available information on construction contracts suggested little improvement in building activity in coming months, prices for commercial real estate had risen slightly and vacancy rates had declined.

Nonfarm business inventories increased rapidly in the second quarter, but there were few signs of inventory imbalances. In June, the pace of inventory investment in manufacturing slowed from the rapid average rate for April and May, and the inventory-shipments ratio for the sector was at a very low level. In wholesale trade, stocks rose sharply in June after little net change over the two previous months. Despite the June increase, the stock-sales ratio was at the middle of its relatively narrow range of the past year. At the retail level, the rise in inventories in June retraced only part of the May decline; the inventory-sales ratio for the sector also was near the middle of its range for the last year.

The nominal deficit on U.S. trade in goods and services was slightly smaller on balance over April and May than the downward-revised average rate in the first quarter. Measured against their first-quarter levels, the value of exported goods and services grew more than the value of imports over the April-May period. The largest increases in exports were in machinery and aircraft and parts, while the biggest gains in imports were in consumer goods, computers, and capital goods other than computers. The available information suggested that in recent months economic activity had expanded further in all the major foreign industrial countries except Japan. Growth continued to be robust in Canada and the United Kingdom and apparently remained moderate in France and Germany. Economic activity in Japan had slowed after a rise in that country's consumption tax in April.

Consumer price inflation picked up slightly in July from the slow pace in each of the previous four months; a small decline in energy prices offset a further increase in food prices. The index for items other than food and energy rose in July at the same low rate recorded for both the first six months of 1997 and the twelve months ended in July. At the producer level, prices of finished goods edged down for a seventh consecutive month, reflecting a further drop in food prices. Prices of finished goods other than food and energy were unchanged over the twelve months ended in July. At earlier stages of production, producer prices for core intermediate materials rose slightly over the year ended in July and prices of core crude materials increased by a larger amount over the same period. Growth in hourly compensation of private industry workers picked up somewhat in the second quarter, but the rise in compensation over the year ended in June matched the advance over the comparable year-earlier period. Average hourly earnings of production and nonsupervisory workers were unchanged in July, and the rise in such earnings over the twelve months ended in July also was the same as in the year-earlier period.

At its meeting on July 1-2, 1997, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions. Because the Committee continued to see a potential need for some tightening of monetary policy to counter rising inflationary pressures, the directive included a bias toward a possible firming of reserve conditions during the intermeeting period. The reserve market conditions associated with this directive were expected to be consistent with moderate growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the average federal funds rate for the period was at the Committee's intended level of 5-1/2 percent. Most other market interest rates declined further on balance over the period in an atmosphere of greater volatility in financial markets. The net decline in market rates seemed to have reflected a judgment by market participants that the outlook for inflation had improved slightly on balance and that the likelihood of any tightening of monetary policy in coming months had receded a little further. Share prices in equity markets increased on balance over the period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose significantly on balance over the intermeeting period. The appreciation of the dollar was uneven against the currencies of the major foreign industrial countries. The dollar's substantial increase against the German mark and other continental European countries reflected both the continuing favorable developments in the U.S. economy and persisting market concerns that difficulties faced by the major European countries would lead to policies that might detract from strength in the euro. The dollar rose only slightly against the yen. That currency came under downward pressure in reaction to incoming data suggesting a somewhat- greater-than-expected falloff in demand following the recent increase in the consumption tax, but the release of the June current account surplus late in the intermeeting period rekindled market concerns about Japanese external balances and led to some appreciation of the yen.

M2 expanded at a moderate pace over June and July after having fluctuated sharply in April and May as a result of tax-related flows. Data for early August suggested a somewhat faster rate of M2 growth in association with heavier inflows to retail money funds; the latter might have been related to heightened demand for liquidity as a result of recently higher volatility in bond and equity markets. For the year through July, M2 expanded at a rate near the upper bound of its range. M3 also fluctuated sharply over April and May and grew at a relatively moderate rate in June. M3 surged in July, however, as heavy volumes of large time deposits were issued by U.S. branches of foreign banks to pay down borrowings from their overseas offices and by domestic banks to counter the runoff of government deposit accounts; the latter two sources of funds are not included in M3. For the year through July, M3 expanded at a rate appreciably above the upper bound of its range. Total domestic nonfinancial debt had continued to expand in recent months at a rate near the middle of its range.

The staff forecast prepared for this meeting suggested that the expansion of the economy would be damped in the second half of the year by a slowing of inventory accumulation from the unsustainably brisk pace in the first half of the year. In 1998, the economy would expand at a pace in line with the growth of its estimated potential. Growth of consumer spending, supported by high levels of household wealth and projected further gains in employment and income, was expected to be relatively brisk over the forecast horizon. Business spending on equipment and structures was anticipated to continue to outpace the overall expansion of the economy, though the differential would tend to narrow over time in association with the gradual diminution of increases in sales and profits that was expected in conjunction with moderating economic growth. Housing construction was projected to drift lower over the forecast horizon. The staff anticipated that the external sector would exert some mild restraint on the expansion of economic activity. With labor compensation gradually accelerating in the context of higher resource utilization, core consumer price inflation was forecast to drift slightly higher.

The Committee's discussion of current and prospective economic developments highlighted statistical and anecdotal evidence of a solid economic performance, including indications of a rebound in final demand after a lull during the spring and the persistence of relatively subdued, and by some measures declining, inflation. Growth in consumer spending had slowed sharply and a surge in inventory accumulation had accounted for much of the expansion of economic activity in the second quarter. Looking ahead, the members did not believe that recent developments had altered the prospect that the economy would settle into a pattern of moderate growth approximating its potential. Such a forecast was subject to considerable uncertainty, and several members observed that the risks appeared to be mostly in the direction of stronger growth in demand. With regard to the outlook for inflation, widespread evidence of very tight labor markets was associated with scattered indications that the rise in labor compensation might be accelerating, but overall labor costs had remained relatively damped and price inflation restrained. Gains in productivity and muted increases in nonlabor costs probably also were contributing to holding producer costs under good control. Nonetheless, the members remained concerned about the risks of rising inflation, especially if somewhat-faster-than-projected growth in economic activity were to occur and add to pressures on resources in an economy that already seemed to be operating close to, or perhaps even above, its sustainable potential.

The uncertain prospects for inventory investment were a dominant factor in the outlook for economic activity over the nearer term. The accumulation of inventories had been unusually high in the second quarter according to the available evidence. There was no broad sense of an undesired buildup, but the rate of inventory investment would have to be reined in if an overhang were to be averted. A concern in this regard was that the apparent upturn in final demand, particularly if it proved to be somewhat stronger than currently expected, and related business optimism about sales prospects might well result in a further buildup of inventories at a relatively rapid rate. While such a development was not viewed as the most likely outcome and, indeed, less-than-projected strength in the inventory sector could not be ruled out, relatively rapid inventory accumulation in the context of persisting above-trend growth in final demand would generate additional pressure on resources and heighten the risks of accelerating inflation.

With regard to the prospects for final demand in key sectors of the economy, members noted that the appreciable rebound in consumer spending followed a weak second quarter, and some moderation in the growth of such spending was likely later this year and in 1998. Even so, favorable prospects for employment and incomes and the large gains that had occurred in financial wealth suggested that consumer expenditures were likely to be well maintained over the projection horizon. The high level of consumer confidence reported by consumer surveys was another supporting factor in this favorable outlook.

In the area of business fixed investment, a strong upward trend in outlays for new equipment was thought likely to persist, notably in the computer-related and the telecommunications industries. Anecdotal reports also pointed to appreciable strength in commercial construction activity, including office structures, hotels, and warehouses in various parts of the country. Indeed, in some areas construction activity was said to be limited only by shortages of qualified labor. Positive factors in the outlook for business investment included the persistence of a high level of profits, an accommodative financial climate, and the rapid obsolescence of high-tech equipment. There were, nonetheless, indications of some moderation in commercial construction activity in a number of areas, including reports of developing overcapacity of retail space in shopping centers. Spending for basic industrial equipment also was likely to soften, given moderating growth in overall final demand in line with current forecasts.

Housing activity continued to display considerable vigor in many parts of the nation as evidenced by available statistics and anecdotal reports. The affordability of housing and the very large increases that had occurred in stock market wealth clearly were supportive factors. Concurrently, however, there were indications of slowing in residential building activity in several areas. On balance, some moderation in housing construction appeared likely over the projection horizon in keeping with longer-term population and other trends affecting such construction.

In the Committee's discussion of the prospects for inflation, members commented that a number of factors could be cited to explain the persistence of relatively subdued inflation this year despite high levels of resource use. Among those factors were the appreciation of the dollar and its effects on prices of imports and competing domestic products, a significant decline in world oil prices, the relatively sluggish performance of many foreign economies that had tended to moderate prices of products traded in world markets, and relatively large grain harvests in the United States that had curbed pressures on food prices. However, the underlying reasons for the favorable price trends were not entirely clear. Labor costs were still rising appreciably less than would have been expected on the basis of past experience under similarly tight labor market conditions. Explanations tended to focus on the concerns about job security felt by many workers, the muted rise in the costs of worker benefits, notably for health care, and the increased use of innovative and highly targeted methods of compensation. With regard to the market pricing of goods, businesses tended to cite highly competitive conditions across the nation that made it very difficult to raise prices and gave impetus to efforts to improve productivity. Indeed, the available evidence suggested that the profits of business concerns generally had continued to increase in the second quarter, implying that productivity had been rising at a pace that exceeded published estimates by a significant margin.

Even though inflation had not accelerated, some signs were beginning to emerge that wages and other labor costs might be experiencing increasing pressure. These included some limited evidence that job security concerns might be diminishing and multiplying anecdotal reports of a less benign outlook for health care costs. Some members commented that the outcome of the recent labor negotiations involving a very large package delivery firm might well be a harbinger of more militant labor negotiating attitudes. Against this background, members expressed concern that a further increase in labor utilization rates could put substantial upward pressures on wages that eventually would work their way through to prices.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance. Underlying economic conditions and the outlook for economic activity and inflation had changed little in recent months. The most likely outcome of the current policy stance was growth near potential and some pickup in inflation as the effects of special factors holding it down abated. For the present, monetary policy appeared to be appropriately positioned to foster the Committee's objectives of resisting an intensification of inflationary pressures while supporting a fully employed economy. The level of real short-term interest rates was relatively high by historical standards and provided some assurance that the current stance of policy would not accommodate a significant increase in underlying inflationary pressures. Nonetheless, the members remained concerned about the outlook for inflation. Although some decline in inflation could not be ruled out, persistence of the current degree of tightness in labor markets, consistent with the economy growing at a pace near its potential, could at some point begin to put more pressure on costs and prices, and growth somewhat above potential, which some members saw as a distinct possibility, would be even more likely to produce that result. While there were no current indications that inflation might be accelerating and no policy move was called for at this time, the members saw a need for continuing vigilance. As at earlier meetings, a number of them expressed the view that an anticipatory policy move to counter intensifying inflationary pressures likely would be needed at some point.

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 a rise in inflation. Accordingly, while they did not attach a high probability to the prospect that the incoming information would warrant a tightening move during the intermeeting period, they continued to view the next policy move as more likely to be in the direction of some firming than toward easing.

The members reviewed proposals for rewording the operational paragraph of the directive for the purpose of updating and clarifying the description of the Committee's instructions to the Manager of the System Open Market Account and to conform the directive wording with current public announcement practices regarding the Committee's policy decisions. In particular, the directive would in the future include specific reference to the federal funds rate that the Committee judged to be consistent with the stance of monetary policy. The Committee also modified the present sentence relating to the intermeeting bias in the directive to recognize that changes in the stance of policy are now expressed in terms of the federal funds rate. These changes were not intended to alter the substance of the directive or the Committee's operating procedures.

At the conclusion of the Committee's discussion, all the members expressed their support of a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5-1/2 percent. All the members also agreed on the desirability of retaining a bias in the directive toward the possible firming of reserve conditions and a higher federal funds rate 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 a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate 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 is expanding at a moderate pace. In labor markets, hiring remained robust at midyear, and the civilian unemployment rate, at 4.8 percent in July, matched its low for the current economic expansion. Industrial production increased relatively slowly in July, owing in part to a temporary drop in motor vehicle assemblies. Retail sales rose briskly in June and July after having changed little over the preceding three months. Housing starts rebounded in June and July after having weakened in May. Business fixed investment increased substantially further in the second quarter and available indicators point to further sizable gains in the current quarter. The nominal deficit on U.S. trade in goods and services narrowed slightly on balance over April and May from its downward-revised average rate in the first quarter. Price inflation has remained subdued and increases in labor compensation have been moderate.
>
> Market interest rates generally have declined somewhat further since the start of the Committee meeting on July 1-2, 1997. Share prices in equity markets have increased on balance. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose significantly on balance over the intermeeting period.
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> After fluctuating sharply from April to May, growth of M2 was at a moderate pace over June and July and that of M3 picked up to a relatively rapid rate. For the year through July, M2 expanded at a rate near the upper bound of its range for the year and M3 at a rate appreciably above the upper bound of its range. Total domestic nonfinancial debt has continued to expand in recent months at a rate near the middle of its range.
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> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on a tentative basis to set the same ranges as in 1997 for

growth of the monetary aggregates and debt, measured from the fourth quarter of 1997 to the fourth quarter of 1998. 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 conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5-1/2 percent. 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, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in 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.

Rules Regarding Availability of Information
By notation vote completed on August 20, 1997, the Committee approved for public comment a revision of its Rules Regarding the Availability of Information. The purpose of the revision is to bring the rules into conformance with the Electronic Freedom of Information Act of 1996 (EFOIA), which amends the Freedom of Information Act (FOIA). The revision does not incorporate any substantive changes in the rules other than to conform them to the requirements of EFOIA and to update and clarify the Committee's procedures for processing FOIA requests. After review of the comments that are received from the public, the Committee will issue the rules in final form on or before October 2, 1997.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 30, 1997.

The meeting adjourned at 12:40 p.m.

Donald L. Kohn
Secretary

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