The Federal Reserve Board

Minutes of the Federal Open Market Committee

Meeting of November 12, 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 Wednesday, November 12, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
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. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

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

Mr. Fisher, Manager, System Open Market Account

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

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

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

Ms. Pianalto and Mr. Rives, First Vice Presidents, Federal Reserve Banks of Cleveland and St. Louis respectively

Messrs. Dewald, Hakkio, Rolnick, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, Minneapolis, and Cleveland respectively

Messrs. Bentley, Meyer, and Rosengren, Vice Presidents, Federal Reserve Banks of New York, Philadelphia, and Boston respectively

Ms. Gonczy and Mr. Koenig, Assistant Vice Presidents, Federal Reserve Banks of Chicago and Dallas respectively

Mr. Trehan, Research Officer, Federal Reserve Bank of San Francisco

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By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on September 30, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on September 30, 1997. 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 September 30, 1997, through November 11, 1997. By unanimous vote, the Committee ratified these transactions.

By unanimous vote, paragraph 1.A of the Authorization for Domestic Open Market Operations was amended to raise from $8 billion to $12 billion the dollar limit on intermeeting changes in System Account holdings of U.S. government and federal agency securities for the intermeeting period through December 16, 1997. The Manager advised the Committee that, as was usually the case at this time of year, the anticipated pattern of reserve needs was such that he might want to add considerably to the System's outright holdings of U.S. government securities over the coming intermeeting period. By unanimous notation vote, the Committee subsequently approved a further increase in the intermeeting leeway to $17 billion. The increase, effective December 8, was made on the recommendation of the Manager who saw the need for substantially more outright purchases of Treasury obligations than anticipated earlier, largely in light of much greater than projected growth in currency.

With Mr. Broaddus dissenting, the Committee authorized the renewal for an additional one-year period of the System's reciprocal currency ("swap") arrangements with foreign central banks and the Bank for International Settlements. The amounts and current maturity dates of the arrangements approved for renewal are shown in the table that follows:

Foreign **Bank**	**Amount of** **Arrangement**	**Term** (months)	**Maturity** **Date**

	(millions of $ equivalent)		
Austrian National Bank	250.0	12 mos.	12/04/97
Bank of England	3,000.0	"	12/04/97
Bank of Japan	5,000.0	"	12/04/97
Bank of Norway	250.0	"	12/04/97
Bank of Sweden	300.0	"	12/04/97
Swiss National Bank	4,000.0	"	12/04/97
Bank for International Settlements--			
Swiss francs	600.0	"	12/04/97
Other authorized European currencies	1,250.0	"	12/04/97
Bank of Mexico	3,000.0	"	12/12/97
Bank of Canada	2,000.0	"	12/15/97
National Bank of Belgium	1,000.0	"	12/18/97
National Bank of Denmark	250.0	"	12/28/97
Bank of France	2,000.0	"	12/28/97
German Federal Bank	6,000.0	"	12/28/97
Bank of Italy	3,000.0	"	12/28/97
Netherlands Bank	500.0	"	12/28/97

Mr. Broaddus dissented because he believed that the Federal Reserve's participation in foreign exchange market intervention compromises its ability to conduct monetary policy effectively. Because sterilized intervention cannot have sustained effects in the absence of conforming monetary policy actions, Federal Reserve participation in foreign exchange operations risks one of two undesirable outcomes. First, the independence of monetary policy is jeopardized if the System adjusts its policy actions to support short- term foreign exchange objectives set by the Treasury. Alternatively, the credibility of monetary policy is damaged if the System does not follow interventions with compatible policy actions, the interventions consequently fail to achieve their objectives, and the System is associated in the mind of the public with the failed operations. In these circumstances, he did not view renewal of the existing swap lines as desirable because they are used primarily to facilitate market intervention.

The Committee then turned to a discussion of the economic outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at the meeting suggested that economic activity continued to grow rapidly in recent months. The further advance reflected a surge in business fixed investment and consumer spending, while housing demand remained at a high level. Significant slowing in exports and inventory investment provided only a partial offset to the strength. Accordingly, production and employment recorded further large gains. Price inflation remained subdued despite tight labor markets and a pickup in the pace of labor compensation.

Nonfarm payroll employment rose substantially further in October. Manufacturing payrolls recorded their largest rise in the current economic expansion, and aggregate weekly hours worked increased significantly; most of the gain in payrolls occurred at durable goods establishments. Hiring remained robust in the service- producing sector, led by sizable increases at computer services and engineering and management services firms. The civilian unemployment rate fell to 4.7 percent in October, its low for the current expansion.

Industrial production registered a large advance in the third quarter and apparently remained strong in October. A third-quarter surge in the manufacture of durable goods, notably of motor vehicles, aircraft, and information-processing equipment, more than offset weak expansion in the output of nondurable goods and a decline in mining activity. Although the step-up in manufacturing production boosted further the rate of utilization of manufacturing capacity, the latter was somewhat below its most recent peak in January 1995.

Retail sales posted a sharp rise in the third quarter, though growth in sales of both durable and nondurable goods moderated during the quarter. Consumer spending on services also continued to increase at a relatively brisk pace. Growth in such spending was underpinned by continuing substantial gains in incomes, the cumulative increase in household net worth over the past several years, and the ready availability of credit to most consumers. Housing demand remained strong in the third quarter in association with moderate interest rates and very positive consumer assessments of homebuying conditions. Sales of both new and existing homes increased a bit, and housing starts were little changed in the third quarter from the high level recorded during the first half of the year.

Business fixed investment increased at an unusually rapid rate in the third quarter. The rise in outlays was spread across all categories of producers' durable equipment, but the largest gains were in office, computing, and communications equipment. Available data on new orders pointed to further broad-based and robust expansion in equipment spending in coming months. Nonresidential construction grew at a moderate pace in the latest quarter despite a decline in September. Available information suggested that construction would trend upward at a modest rate in coming months.

Business inventory investment appeared to have moderated substantially in the third quarter from the rapid rate of the previous quarter, and on balance stocks were at relatively low levels in relation to sales. In manufacturing, stocks rose somewhat further in September, but the inventory-to-shipments ratio for the sector declined to the low end of its range for the past twelve months. Wholesale inventories posted another sizable advance in September; the inventory-sales ratio for this sector was just above the high end of its range for the past year. Retail stocks fell in August (latest available data), more than reversing their July increase. The inventory-sales ratio for the sector also was at the low end of its range for the past year.

The nominal deficit on U.S. trade in goods and services widened substantially on balance over July and August from its rate in the second quarter. Exports of goods and services changed little on net in the July-August period but imports rose considerably; the largest increases in imports were for aircraft and automotive products, but sizable gains also were recorded for computers, semiconductors, and industrial supplies. Available indicators of economic activity in the third quarter pointed to robust expansion in all the major foreign industrial countries except Japan, where activity rebounded only moderately from a sharp second-quarter decline. Although timely data were sparse, the economies of many Asian countries probably were weakening as their exchange rates came under pressure, problems in their financial sectors were revealed, and their monetary and fiscal policies moved toward restraint.

Consumer price inflation remained subdued in September. The increase in both overall consumer prices and the prices of consumer items other than food and energy was modest. For the twelve months ended in September, prices of consumer items other than food and energy increased by a considerably smaller amount than in the year- earlier period. At the producer level, the September rise in prices was the largest monthly increment since January 1991; nonetheless, the overall index was unchanged over the past twelve months after a sizable rise over the previous twelve-month period. The core index also decelerated on a year-over-year basis. The rate of increase in the hourly compensation of private industry workers was unchanged in the third quarter, but the advance over the past four quarters was somewhat larger than that for the previous four. Growth in average hourly earnings picked up in September and October, perhaps partly reflecting the effects of an increase in the federal minimum wage.

At its meeting on September 30, 1997, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging around 5-1/2 percent. The Committee retained a tilt in the directive toward a possible firming of reserve conditions during the inter- meeting period, reflecting its view that the risks continued to be skewed toward rising inflation. Reserve market conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations were directed throughout the inter- meeting period toward maintaining reserve conditions consistent with the Committee's intended level of around 5-1/2 percent for the federal funds rate, and the rate averaged close to that level over the period. Other financial markets became quite volatile from time to time. Share prices in equity markets fluctuated widely in occasionally turbulent trading activity and were down somewhat on balance over the period; equity markets in other countries, notably in Asia, also were volatile, and very large declines were recorded in some of those markets. Against this background, U.S. short-term interest rates registered small mixed changes over the period since the September 30 meeting, while Treasury bond yields declined somewhat on balance. Unexpectedly strong incoming data on U.S. producer prices, employment, and wages tended to exert upward pressures on bond yields on some days, but these were more than offset by investor desires for safety and quality, the continuing moderation in consumer inflation, and the perception engendered by international financial developments that inflation pressures were likely to remain subdued.

The dollar also was affected by the spreading financial turmoil in developing countries, appreciating significantly over the intermeeting period against the currencies of a number of Asian and Latin American countries. Much of the increase was counterbalanced, however, by a sizable decline in the dollar's trade-weighted value in terms of the currencies of the other G-10 countries. The dollar's decline against the German mark and other European currencies partly reflected diminished market expectations of potential tightening in the United States and a snugging of monetary conditions by the Bundesbank and other continental European central banks. Further progress in resolving uncertainties surrounding the European Monetary Union also may have contributed to the rise in European currencies. The dollar appreciated slightly on balance against the Japanese yen.

Growth of M2 and M3 apparently moderated further in October, though the expansion of these aggregates remained brisk. A sharp slowing of inflows to money market mutual funds accounted for much of the deceleration of M2, and an easing in the pace of issuance of large time deposits, evidently reflecting a smaller rise in bank credit, also contributed to a modest reduction in M3 growth. For the year through October, M2 expanded at a rate that was at the upper bound of the Committee's range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt increased in recent months at a rate somewhat below the middle of its range.

The staff forecast prepared for this meeting suggested that the economy would continue to expand for a time at a pace considerably above its potential, but growth was expected to moderate to a more sustainable rate later. Further rapid increases in business investment would provide strong impetus to income growth in the near term, and the rise in household wealth so far in 1997 would stimulate robust consumer demand going forward. The projected strength of domestic demand would be offset to some extent by a considerable weakening in the growth of exports in response to the lagged effects of the earlier appreciation of the dollar and sharp anticipated reductions in the economic growth of Asian and other developing countries.

In the Committee's discussion of current and prospective economic developments, members focused on widespread indications of a continued solid advance in economic activity, spurred by strength in all major sectors of the domestic economy, and the persistence of subdued increases in prices. The current momentum of the expansion, together with broadly supportive financial conditions and favorable business and consumer sentiment, suggested that economic growth was likely to be well maintained, especially over the nearer term. As a consequence, the members agreed that there remained a clear risk of additional pressures on already tight resources and ultimately on prices that could well need to be curbed by tighter monetary policy. But the members also focused on two important influences that were injecting new uncertainties into this outlook. Turmoil in Asian financial markets and economies would tend to damp output and prices in the United States. To date, it appeared that the effects on the U.S. economy would be quite limited, but the ultimate extent of the adjustment in Asia was unknown, as was its spillover to global financial markets and to the economies of nations that were important U.S. trading partners. The second influence was the apparently sharp increase in productivity in the second and third quarters. This was an encouraging development, although it was too early to judge the persistence of the uptrend in productivity growth and the extent to which it might reduce the additional price pressures that would be generated in the event of an extended period of further robust economic expansion.

Strength in consumer spending had provided an important underpinning for robust economic expansion, and substantial growth was likely to persist, sustained by increases in employment and incomes, high levels of confidence, and the cumulative effects of very large gains in stock market wealth over the past several years. The outlook for capital spending also remained quite favorable because the factors that were contributing to the ongoing surge in such spending--its potential for lowering production costs in highly competitive markets and the ready availability of finance on attractive terms--were likely to persist. While private domestic demand most likely would continue to display considerable strength, both consumption and investment were somewhat vulnerable to developments in financial markets, perhaps arising from further difficulties in Asia. Increased uncertainty about asset values could engender greater caution on spending, and of course a substantial decline in equity values would reduce household wealth and raise the cost of equity capital. Some members also commented that additional appreciation of the dollar, perhaps in association with possible further turbulence in Asia and weakness in foreign economies, would have adverse implications for net exports, which already were seen as a somewhat negative factor in the economic outlook. At the same time, of course, a stronger dollar would have a positive effect on domestic inflation over the projection horizon.

In the course of their discussion, the members gave consider- able emphasis to recent developments in labor markets. Statistical indicators of rising levels of employment, low and falling rates of unemployment, and a diminishing supply of new workers were reinforced by anecdotal evidence of tight labor markets throughout the nation. The demand for many types of workers exceeded the supply in many regions, and a number of members reported that growth of economic activity in various parts of the country was being held back by the scarcity of labor. While labor compensation had accelerated, the pickup was moderate in light of the taut conditions in labor markets and some of it reflected the legislated rise in the minimum wage. Nonetheless, members cited numerous examples of efforts to attract or retain workers in especially scarce supply through a variety of bonus payments and other incentives that were not included in standard measures of labor compensation.

The effects on costs and prices of somewhat faster increases in compensation evidently were being muted by what appeared to have been a sharp advance in productivity growth in the last two quarters. The acceleration in productivity seemed to be related in part to the surge in capital spending, which had been stimulated by the ability of new equipment to enhance efficiency and hold down costs, suggesting that productivity might be on a higher trend for a time. But it also could be attributed to some extent to the strengthening in economic output; such strengthening often is associated with a pickup in productivity as producers react initially to the upturn in demand by stretching available labor further. If the pace of the economic expansion were to moderate in line with current expectations, the growth in productivity could also be expected to slow, but to an uncertain extent.

The trend in productivity gains was a key factor in the outlook for unit costs and ultimately for price inflation. As had been true for an extended period, inflation had remained relatively subdued in comparison with past experience under broadly similar economic conditions. The reasons for the relative quiescence of inflation were not fully understood, but they undoubtedly included a number of special factors beyond higher productivity such as a lagged response to earlier appreciation of the dollar and unusually damped increases in the cost of health benefits. As they had at previous meetings, members suggested that these favorable influences were likely to erode over the year ahead. A number of members again cited reports of increases in health insurance premiums next year and subsequently. More fundamentally, it was difficult to predict whether anticipated increases in labor compensation would be fully offset by productivity gains in coming quarters and whether, in turn, competitive market conditions would allow firms to raise prices to compensate for any increases in their costs. On balance, the members felt that the risks remained in the direction of rising price inflation though the extent and timing of that outcome were subject to considerable debate.

In the Committee's discussion of policy for the intermeeting period ahead, all but one member endorsed a proposal to maintain an unchanged policy stance, and all agreed that the risks remained tilted toward rising inflation. While developments in Southeast Asia were not expected to have much effect on the U.S. economy, global financial markets had not yet settled down and further adverse developments could have greater-than-anticipated spillover effects on the ongoing expansion. In this environment, with markets still skittish, a tightening of U.S. monetary policy risked an oversized reaction. Some members also emphasized that the relatively favorable trends in productivity, costs, and prices continued to raise questions about the strength and timing of any pickup in inflation. Other members stressed that the unsustainable pace of domestic demand and rising resource utilization seemed to call for a near-term tightening of policy. Some of these members noted that overall financial conditions remained quite supportive despite the recent market turmoil and high real short-term interest rates. Credit from a wide variety of lenders appeared to be amply available on favorable terms, perhaps overly so in present circumstances. Nonetheless, all but one of the members believed that in light of the uncertainties about the economic outlook, an immediate policy tightening was not needed in the absence of firmer indications that inflationary pressures might be emerging. In the view of one member, however, aggregate final demand was so strong that, with economic activity and the associated demand for labor having expanded at an unsustainable pace for some time, one could be reasonably confident that inflation would most likely pick up in the absence of policy action.

In their discussion of possible adjustments to policy during the intermeeting period, the members indicated that they wanted to retain in the operating paragraph of the directive the existing asymmetry toward restraint that was initially adopted at the May meeting. Such a directive was consistent with their view that the risks continued to be biased toward rising inflation. Accordingly, the members continued to view the next policy move as more likely to be in the direction of some firming than toward easing.

At the conclusion of the Committee's discussion, all but one member supported 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 and that retained a bias 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 growth 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 continued to grow rapidly in recent months. In labor markets, hiring has remained robust and the civilian unemployment rate fell to 4.7 percent in October, its low for the current economic expansion. Industrial production increased very rapidly in the third quarter, and appears to have remained strong in October. Retail sales also rose sharply in the third quarter, though at a moderating pace as the summer progressed. Housing starts, while fluctuating from month to month, were little changed on balance in the third quarter. Business fixed investment posted unusually strong increases in the latest quarter, and available indicators point to further sizable gains in coming months. The nominal deficit on U.S. trade in goods and services widened substantially on average in July and August from its rate in the second quarter. Price inflation has remained subdued despite some increase in the pace of advance in labor compensation.

Short-term interest rates have registered small mixed changes since the day before the Committee meeting on September 30, 1997, while bond yields have fallen somewhat. Share prices in U.S. equity markets have fluctuated widely in turbulent trading activity and are down on balance over the period; equity markets in other countries, notably in Asia, have been volatile as well and some have registered very large declines. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined somewhat on balance over the intermeeting period. The dollar appreciated significantly, however, in terms of the currencies of a number of Asian and Latin American countries.

Growth of M2 and M3 appears to have moderated further in October from the unusually brisk rates of August. For the year through October, M2 expanded at the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat below the middle 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 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 develop- ments 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 consider- ation 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, Ferguson, Gramlich, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin.

Vote against this action: Mr. Broaddus.

Mr. Broaddus dissented because he believed that a modest tightening of policy would be prudent in view of the recent strength in aggregate demand for goods and services; such demand appeared to be growing considerably more rapidly than the sustainable rate at which it could be supplied without an increase in inflation. While he recognized that a tightening at this meeting presented risks in view of recent financial and economic developments in East Asia, he believed these risks were outweighed by the risk that policy would have to be tightened more aggressively if action were delayed, demand remained robust, and the recent apparent reduction in inflationary expectations were reversed. The negative impact on economic activity in such circumstances would be markedly greater than if a more modest action were taken at this meeting.

Rules Regarding Availability of Information
By notation vote the Committee unanimously approved in final form certain revisions to its Rules Regarding the Availability of Information. The final rules take account of comments received from the public on the Committee's proposed revisions to the rules that were published earlier in the Federal Register. The purpose of the revisions is to bring the rules into conformity with the Electronic Freedom of Information Act of 1996 (EFOIA), which amends the Freedom of Information Act (FOIA). The new rules take effect on December 17, 1997.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 16, 1997.

The meeting adjourned at 1:10 p.m.

Donald L. Kohn
Secretary

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