The Federal Reserve Board

Minutes of the Federal Open Market Committee

Meeting of December 16, 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, December 16, 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, 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. Beebe, Cecchetti, Eisenbeis, Goodfriend, Lindsey, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

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

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

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

Messrs. Connolly and Rives, First Vice Presidents, Federal Reserve Banks of Boston and St. Louis respectively

Mses. Browne, Krieger, Messrs. Dewald, Hakkio, Lang, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Boston, New York, St. Louis, Kansas City, Philadelphia, and Dallas respectively

Mr. Miller, Vice President, Federal Reserve Bank of Minneapolis

Messrs. Bryan and Evans, Assistant Vice Presidents, Federal Reserve Banks of Cleveland and Chicago respectively

---

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 12, 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 November 12, 1997. There were no open market 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 November 12, 1997, through December 15, 1997. By unanimous vote, the Committee ratified these transactions.

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 this meeting suggested that economic activity had continued to grow at a rapid pace in recent months. The further advance reflected moderating but still sizable increases in business fixed investment and consumer spending and an upturn in business inventory accumulation. Housing demand remained at a high level, and deepening trade deficits provided only a partial offset to the strength in domestic spending. Against this background, employment and production posted further large gains. Price inflation remained subdued despite tight labor markets and some pickup in the rate of wage increases.

Nonfarm payroll employment rose sharply further in October and November. The increases in payrolls were widespread across sectors, and in November they included notably large gains in the service- producing industries. Manufacturing employment also rose considerably further in November, and aggregate weekly hours of production or nonsupervisory workers registered a particularly large advance in that month. The civilian unemployment rate fell to 4.6 percent in November, its low for the current expansion.

Industrial production continued to advance at a brisk pace in October and November. The November increase was widespread across market groups. It featured particularly strong growth in the production of durable goods, including a surge in the output of motor vehicles and parts. Partly offsetting the strength in the manufacturing sector in November was a decline in mining activity and in utilities output after two months of robust expansion. The large rise in production boosted the rate of utilization of manufacturing capacity to its highest level in more than two years.

Growth in consumer spending had moderated in recent months from a very brisk pace during the summer. Retail sales were unchanged on balance over October and November after having increased rapidly in the third quarter. The flat sales for the two months reflected some softening in the durable goods category, notably at automotive dealers, and relatively slow growth in the nondurable goods sector. Consumer spending on services appeared to have remained relatively robust in October. According to recent surveys, consumer sentiment remained at an extraordinarily ebullient level in the context of continuing strong gains in jobs and incomes, the cumulative effect of large increases in household net worth, and the ready availability of financing for most consumers.

Available information suggested that business capital expenditures had moderated in recent months from the exceptionally strong increases of the second and third quarters. Shipments of office and computing equipment fell in nominal terms in October, while shipments of communications equipment were about unchanged after having posted strong gains earlier in the year. Shipments of nondefense capital goods other than aircraft and high-tech equipment also declined in October. Spending on nonresidential structures had softened a bit in recent months.

In the housing sector, demand had continued to display appreciable strength in recent months in association with relatively moderate mortgage rates and very positive consumer assessments of homebuying conditions. In October, the latest month for which data were available, sales of new homes were well maintained, and sales of existing homes rose. Housing starts increased somewhat in October and November from the already high level reached earlier in the year.

After picking up considerably in September, the pace of business inventory investment in October remained above that recorded earlier in the summer. The rise in stocks at the manufacturing level was at a somewhat faster pace in October than in September, but the buildup in inventories at the wholesale level, and especially at the retail level, moderated in October. On balance, inventories remained at quite low levels in relation to shipments and sales.

The nominal deficit on U.S. trade in goods and services was significantly larger in the third quarter than in the second. Exports of goods and services rose only marginally in the third quarter, as increases in machinery, industrial supplies, and service receipts were nearly offset by sharp declines in exports of aircraft and gold. Imports of goods and services rose appreciably in the third quarter; the increases were in most major trade categories and included strong further advances in the quantity of oil imports. Economic growth in most major foreign industrial countries was relatively vigorous in the third quarter, and preliminary indicators for the fourth quarter suggested continued above-trend expansion. However, growth since midyear appeared to have recovered only modestly in Japan from a sharp second-quarter decline. The ongoing financial turmoil affecting a number of Asian economies had led to a significant slowdown in economic activity in the region. Available data also suggested a favorable economic performance in major Latin American countries in the third quarter.

Consumer price inflation had remained at a low level in recent months, reflecting a variety of influences including a favorable labor cost environment, falling import prices, small increases in energy prices, and declining inflation expectations. For the twelve months ended in November, overall consumer prices and consumer prices excluding food and energy items increased appreciably less than in the year-earlier period. At the producer level, prices for finished goods edged lower in November and the index was down somewhat on balance over the past year, reflecting declines in the food and energy components. The rate of increase in average hourly earnings had picked up in recent months, apparently reflecting the effects of an increase in the federal minimum wage and some bidding up of wages in a tight labor market.

At its meeting on November 12, 1997, the Committee had 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. In the directive the Committee had retained a tilt toward a possible firming of reserve conditions during the intermeeting period. Such a bias had been seen as consistent with the members' views that the risks continued to be skewed toward rising inflation and that the next policy move was more likely to be in the direction of some firming than toward easing. Reserve market conditions associated with this directive had been expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations throughout the intermeeting period were directed toward maintaining reserve conditions consistent with the intended average of around 5-1/2 percent for the federal funds rate, and the average effective rate over the period was close to that rate level. In other domestic financial markets, short-term interest rates registered small mixed changes since the day before the Committee meeting on November 12, 1997, while bond yields fell somewhat. Share prices in U.S. equity markets recorded mixed changes over the period. Domestic financial markets became somewhat less volatile over the period, though further turmoil in a number of foreign markets fostered a sense of unease that was reflected in relatively wide yield spreads and, on occasion, in trading activity and price movements. Equity markets in other countries, notably in Asia, remained volatile.

In foreign exchange markets, the value of the dollar rose over the intermeeting period in terms of both the trade-weighted index of the other G-10 currencies and the currencies of a number of Asian countries. The dollar's appreciation against the German mark and other Western European currencies appeared to reflect market perceptions that the prospects for monetary tightening had ebbed in those countries in light of the persistence of subdued inflation and indications that the continuing financial turmoil in Asian and other emerging economies was likely to have a retarding effect on the economies of the industrial countries. The dollar's appreciation relative to the yen appeared to reflect rising concerns about the Japanese economy in the wake of continuing financial difficulties in Japan and spillover effects from events elsewhere in Asia. The dollar strengthened further in this period against most of the other East Asian currencies, notably against the Korean won.

Growth in the broad monetary aggregates picked up to relatively rapid rates in November. Strength in currency and a surge in liquid deposits boosted the expansion of M2, while that of M3 was amplified by a step-up in RP borrowing to help finance more rapid growth in bank credit. For the year through November, M2 expanded at a rate that was slightly above the upper bound of the Committee's annual range, and M3 at a rate substantially above the upper bound of its range. The increase in total domestic nonfinancial debt for the year to date was at a pace somewhat below the middle of the Committee's range.

The staff forecast prepared for this meeting suggested somewhat greater moderation in economic expansion than had been projected earlier and slightly less pressure on wages and prices. A number of factors were expected to contribute to the slowing of aggregate demand and reduced pressure on resources. These included: a slackening in world economic expansion that, in conjunction with the appreciation of the dollar, would substantially restrain U.S. exports; some moderation of the growth in household and business investment; and a diminution in the desired rate of inventory accumulation.

In the Committee's discussion of current and prospective economic developments, members commented on indications that growth in economic activity had remained solid and that inflation had continued to be surprisingly low. While wages appeared to be increasingly subject to upward pressure, productivity had picked up in recent quarters, and the persisting strength in profits suggested that unit labor costs were not accelerating noticeably. The evidently higher pace of productivity growth was very encouraging, though it was still difficult to assess how long this favorable performance might last and the extent to which it might ease the price pressures that could emerge if the economic expansion did not moderate as members anticipated. Domestic demand for goods and services had been quite strong and was likely to remain reasonably robust. However, the effects of the persisting turmoil in Asian financial markets were likely to moderate the pace of expansion, though the extent of this effect was difficult to judge. The ongoing turbulence since the last Committee meeting, which included further noticeable increases in the dollar against the currencies of affected countries, likely would have a somewhat greater damping effect on output and prices in the United States than previously had been anticipated. Exports to many Asian countries, and possibly to other U.S. trading partners whose economies might be adversely affected by the spillover effects of developments in Asia, would be reduced, and declines in import prices would ease inflation pressures. However, the ultimate extent of the adjustment in Asian economies remained unknown, and more substantial downward pressure on the economies of the United States and its trading partners could not be ruled out.

With regard to the prospects for final demand in key sectors, the members noted that the appreciation of the dollar against a wide range of currencies, along with the prospective slackening in world economic expansion associated with the Asian turmoil, could be expected to exert a considerable damping effect on U.S. exports over the next several quarters. In addition, increased uncertainty about financial asset values, possibly related in part to further difficulties in Asia, could lead to greater caution in spending, while a substantial decline in equity values, should it occur, would have a more pronounced effect by reducing household wealth and raising the cost of equity capital. However, a number of members suggested that consumer spending might hold up relatively well if the effects of the Asian crisis on the U.S. economy were not markedly deeper or more prolonged than currently expected. To date, anecdotal reports indicated only scattered signs of weaker export demand, primarily some slackening in orders for and shipments of selected commodities such as agricultural goods and lumber and wood products, and there were few indications of reduced demand for manufactured goods. At the same time, business contacts were optimistic about holiday sales, tourism was booming in some parts of the country, and spending for services had been brisk. In the circumstances, continuing gains in wages and employment, the prevailing high levels of confidence, the cumulative effects of very large increases in household wealth in recent years, and the intense competition among retailers for the consumer's attention could promote substantial further growth in consumer expenditures. The same factors, along with the favorable cash-flow affordability of home ownership, were maintaining housing demand at a relatively high level.

The outlook for business fixed investment remained favorable. In the near term, the low cost of capital, the ready availability of finance on attractive terms, and the potential for reducing production costs in highly competitive markets were providing strong support for capital spending. Moreover, shrinking vacancy rates and rising lease rates were fostering a rapid increase in the number of large commercial building projects, notably office buildings, that were planned or under way in many areas of the country. Even so, the growth of business capital spending was expected to slow from the unusually rapid pace of recent quarters in response to the projected smaller increases in sales and profits arising from moderating economic growth. In addition, business firms were expected to trim the pace of their inventory accumulation to keep stocks at desired levels relative to sales.

In their comments on recent developments in labor markets, the members emphasized the very limited supply of new workers and the extraordinary tightness prevailing in markets throughout the nation. Several reported that the scarcity of available workers was limiting the growth of economic activity in some parts of the country and that some employers were trying out novel approaches aimed at enticing people not currently seeking a job to enter the work force. While wage increases remained moderate on balance, larger increases were gradually becoming more pervasive as labor markets tightened. Moreover, employers were continuing their efforts to attract or retain workers that were in particularly scarce supply by means of a variety of bonus payments and other incentives that were not included in standard measures of labor compensation. There also were reports of offers of expanded benefits and, in some instances, the granting of very large wage increases to highly skilled technical personnel.

In the course of their discussion, many members remarked on the absence of inflationary price pressures during a period when economic activity had risen briskly and labor markets had grown steadily tighter. The muted effect of higher labor compensation on unit labor costs and prices reflected sharp advances in productivity partly associated with the rapid expansion of the stock of capital; the latter had been stimulated, most probably, by the desire to enhance efficiency and thus hold down costs. In addition, the earlier appreciation of the dollar and the unusually damped increases in the cost of health benefits in recent years had helped to limit the rise in compensation.

As members had noted at previous meetings, these favorable influences were likely to erode over time. Anecdotal reports indicated that health insurance premiums were beginning to trend higher, and the dollar would not rise indefinitely. More fundamentally, persistent tightness in labor markets risked a continuing uptrend in labor compensation increases that, at some point, could not be fully offset by productivity gains. Under those circumstances, competitive market conditions would allow firms to raise prices to compensate for increases in their costs. However, for some period ahead, developments associated with the turmoil in Asia along with the partly related appreciation of the dollar would tend to intensify import competition and damp the prices of goods.

In the Committee's discussion of policy for the intermeeting period ahead, nearly all the members favored a proposal to maintain an unchanged policy stance. In their discussion, members emphasized that price inflation had remained subdued, indeed with some key price measures indicating declining inflation, despite the persistence of robust economic growth and high levels of resource use, notably in labor markets. They expressed concern, however, that multiplying indications of faster wage increases might presage rising price inflation at some point. Weighing against the risks of higher inflation was the financial turmoil that had intensified in Southeast Asia during October and more recently in Korea. The effects of those developments on the U.S. economy were quite limited thus far, but the members expected some damping of economic expansion and price increases in the quarters ahead and they did not rule out a potentially strong impact in the event of an even deeper crisis in Asia, or one that spread to other countries. Nonetheless, many members commented that, with domestic demand still quite strong and the economy possibly producing beyond its potential, they viewed the risks on balance as pointing to rising price inflation and the next policy move as likely to be in the direction of some tightening. However, most members agreed that the need for such a policy adjustment did not appear to be imminent, and that prevailing near-term uncertainties warranted a cautious wait-and-see policy posture. One member, while acknowledging the downside risks to the expansion associated with potential developments in Asia, still was persuaded that the economy probably would continue to expand at an unsustainable pace and that monetary policy should be tightened promptly to avert a further buildup of pressures in already strained labor markets, associated increases in labor costs, and at some point an inevitable rise in price inflation.

Other considerations cited by some members in favor of an unchanged policy included the possibility that, because a policy tightening move was not expected at this juncture, even a modest firming action might well have outsized effects in financial markets, especially the foreign exchange markets. Current conditions in domestic financial markets clearly remained supportive of spending, but it also was noted that the real federal funds rate was relatively high and that growth in the broad measures of money was expected to moderate over coming months after a period of robust expansion. The members agreed that the crosscurrents that were generating the present uncertainties in the outlook for economic activity and inflation made a flexible approach to monetary policy particularly desirable at this juncture.

Views were somewhat more divided with regard to the instruction in the directive relating to the possible adjustment of policy during the intermeeting period. A majority of the members indicated a preference for a shift to a symmetrical directive even though many continued to anticipate that the next policy move was likely to be in a tightening direction. They noted that while the probability of any policy change in the near term was very low, uncertainties in the outlook had increased, and they could not rule out the possibility that the next change might be in the direction of some easing if, contrary to current expectations, the turmoil in Asia were to intensify to the extent that it seemed likely to exert very substantial effects on the U.S. economy. A symmetric directive would position the Committee to respond flexibly in either direction to unanticipated developments in the period ahead. Other members expressed a slight preference for retaining a directive that was tilted toward tightening. In their view, such a directive would continue to underscore their concern that at current and prospective levels of resource utilization, rising inflation was the most serious risk to the economy and the Committee remained committed to fostering progress toward a stable price environment that in turn would heighten the prospects for sustained economic expansion and full employment.

At the conclusion of the Committee's discussion, all but one member endorsed 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 did not include a presumption about the likely direction of any adjustment 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 a slightly higher 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 some moderation in the growth 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 economic activity continued to grow rapidly in recent months. Nonfarm payroll employment increased sharply in October and November; the civilian unemployment rate fell to 4.6 percent in November, its low for the current economic expansion. Industrial production continued to advance at a brisk pace in October and November. Retail sales were unchanged on balance over the two months after rising sharply in the third quarter. Housing starts increased slightly further in October and November. Available information suggests on balance that business fixed investment will slow from the exceptionally strong increases of the second and third quarters. The nominal deficit on U.S. trade in goods and services widened significantly in the third quarter from its rate in the second quarter. Price inflation has remained subdued, despite some increase in the pace of advance in wages.
>
> Short-term interest rates have registered small mixed changes since the day before the Committee meeting on November 12, 1997, while bond yields have fallen somewhat. Share prices in U.S. equity markets recorded mixed changes over the period; equity markets in other countries, notably in Asia, have remained volatile. In foreign exchange markets, the value of the dollar has risen over the intermeeting period in terms of both the trade-weighted index of the other G-10 countries and the currencies of a number of Asian countries.
>
> M2 and M3 grew rapidly in November. For the year through November, M2 expanded at a rate slightly above 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 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 slightly higher federal funds rate or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the 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 continued to believe that a modest tightening of policy would be prudent in light of the apparent persisting strength in aggregate demand for goods and services. He recognized the case for holding policy steady given recent developments in East Asian economies and financial markets; he believed, however, that a slight firming at this meeting would provide valuable insurance against the risk that demand growth might remain above a sustainable trend and require a sharper policy response later. He thought further that the potential benefits of this insurance outweighed the risk that such an action would have a significant negative impact on U.S. economic activity. He also believed that signaling a greater willingness to tolerate modest policy adjustments in response to emerging developments would foster more flexible movements in longer-term financial markets, and specifically enable longer-term interest rates to play their traditional role as automatic stabilizers for the economy more effectively.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, February 3-4, 1998.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Last update: February 5, 1998, 2:00 PM