Minutes of the Federal Open Market Committee

Meeting of February 3-4, 1998

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, February 3, 1998 at 2:30 p.m. and continued on Wednesday, February 4, 1998 at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Ms. Phillips
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, 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

Ms. Browne, Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Promisel, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

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

Mr. Slifman, Associate Director, Division of Research and Statistics, Board of Governors

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

Messrs. Brayton [1] and Rosine,[1] Senior Economists, Division of Research and

Statistics, Board of Governors

Ms. Garrett and Mr. Nelson,[1] Economists, Division of Monetary Affairs, Board of Governors

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

Mr. Rives, First Vice President, Federal Reserve Bank of St. Louis

Messrs. Beebe, Eisenbeis, Hunter, Ms. Krieger, Messrs. Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Chicago, New York, Philadelphia, Minneapolis, and Dallas respectively

Mr. Hetzel, Vice President, Federal Reserve Bank of Richmond

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 1998, and ending December 31, 1998, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

William J. McDonough, President of the Federal Reserve Bank of New York, with Ernest T. Patrikis, First Vice President of the Federal Reserve Bank of New York, as alternate;

Cathy E. Minehan, President of the Federal Reserve Bank of Boston, with Edward G. Boehne, President of the Federal Reserve Bank of Philadelphia, as alternate;

Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, with Michael H. Moskow, President of the Federal Reserve Bank of Chicago, as alternate;

Robert D. McTeer, Jr., President of the Federal Reserve Bank of Dallas, as voting alternate pending the election of a President of the Federal Reserve Bank of St. Louis;

Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, with Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after December 31, 1998, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

Alan Greenspan, Chairman
William J. McDonough, Vice Chairman

Donald L. Kohn, Secretary and Economist
Normand R. V. Bernard, Deputy Secretary
Joseph R. Coyne, Assistant Secretary
Gary P. Gillum, Assistant Secretary
J. Virgil Mattingly, Jr., General Counsel
Thomas C. Baxter, Jr., Deputy General Counsel
Michael J. Prell, Economist
Edwin M. Truman, Economist

Lynn E. Browne, Stephen G. Cecchetti,
William G. Dewald, Craig S. Hakkio,
David E. Lindsey, Larry J. Promisel,
Thomas D. Simpson, Mark S. Sniderman,
and David J. Stockton Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Committee after December 31, 1998.

By unanimous vote, Peter R. Fisher was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.

Secretary's note: Advice subsequently was received that the selection of Mr. Fisher as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York.

On the recommendation of the Manager, the Committee at this meeting unanimously approved two changes in the Authorization for Domestic Open Market Operations.

First, the Committee amended paragraph 1(a) of the Authorization to raise from $8 billion to $12 billion the limit on intermeeting changes in System account holdings of U.S. government and federal agency securities. The increase was the first permanent change in the limit since February 1990 when it was raised from $6 billion to $8 billion. The Manager indicated that the Committee had approved temporary increases several times during the past year and that the existence of a permanent $12 billion limit would have obviated the need for most of the increases. A permanent increase to $12 billion would reduce the the number of occasions requiring special Committee action, while still calling the need for particularly large changes to the Committee's attention. The Committee concurred in the Manager's view that a $4 billion increase was appropriate.

Second, the Committee terminated the Manager's authority to conduct transactions in bankers acceptances. This involved the deletion of paragraph 1(b), which authorized purchases or sales of prime bankers acceptances in the open market, and also the deletion of the reference in paragraph 1(c), which authorized repurchase agreements in such market instruments. The Manager indicate that operations in bankers acceptances were not a practical means of affecting reserves under current circumstances, given the ample availability of U.S. Treasury obligations in the market. Indeed, the Committee previously had decided in 1977 to suspend transactions on an outright basis in bankers acceptances and had completed the System's disengagement from this market in 1984 by instructing the Manager to discontinue the use of repurchase agreements involving bankers acceptances. While those decisions had left open the possibility resuming transactions in bankers acceptances and no changes had been made in the Authorization, the Committee agreed that the existing authority no longer served a practical purpose. Accordingly, the amended Authorization for Domestic Open Market Operations was unanimously approved in the form shown below.

Authorization for Domestic Open Market Operations
Amended February 3, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

> (a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;
> (b) To buy U.S. Government securities and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and

directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph l(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph l(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

With Mr. Jordan dissenting, the Authorization for Foreign Currency Operations shown below was reaffirmed.

Authorization for Foreign Currency Operations
Reaffirmed February 3, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Austrian schillings
Belgian francs
Canadian dollars
Danish kroner
Pounds sterling
French francs
German marks
Italian lire
Japanese yen
Mexican pesos
Netherlands guilders
Norwegian kroner
Swedish kronor
Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	**Amount of arrangement (millions of dollars equivalent)**
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	3,000
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System

foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

With Mr. Jordan dissenting, the Foreign Currency Directive shown below was reaffirmed.

Foreign Currency Directive
Reaffirmed February 3, 1998

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks and with the Bank for International Settlements.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Mr. Jordan dissented in the votes on the Foreign Currency Authorization and the Foreign Currency Directive because these policy instruments provide the basis for foreign exchange market transactions. He believes that the primary mission of the Federal Reserve is to achieve and maintain a stable purchasing power of the U.S. dollar. That objective is best achieved when open market transactions are restricted to purchases and sales of U.S.

government securities. When compatible with the System's primary objective, foreign exchange transactions are redundant to open market operations. Often, however, foreign exchange transactions conflict with the System's primary objective, requiring opposite adjustments in System holdings of U.S. Treasury obligations. Moreover, holdings of foreign securities expose the Reserve Banks to foreign exchange translation losses resulting from the depreciation of foreign currencies relative to a strong and stable U.S. dollar.

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency Operations shown below were reaffirmed.

Procedural Instructions with Respect to Foreign Currency Operations
Reaffirmed February 3, 1998

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

> A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.
>
> B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.
>
> C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.
>
> D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

> A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.
>
> B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

On January 16, 1998, the continuing rules, regulations, authorizations, and other instructions of the Committee had been distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee's attention before the February 3-4 organization meeting to give members an opportunity to raise any questions they might have concerning them. Members were asked to indicate if they wished to have any of the instruments in question placed on the agenda for consideration at this meeting, and no requests for consideration were received.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 16, 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 December 16, 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 of the System Open Market Account also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period from December 17, 1997, through February 3, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook, the ranges for the growth of money and debt in 1998, 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 continued to expand at a robust pace during the closing months of 1997. Both employment and industrial output recorded substantial increases in the fourth quarter. While spending for final goods and services by U.S. residents decelerated noticeably, inventory investment strengthened and the deficit in international trade in goods and services appeared to have narrowed. Tighter labor markets brought some acceleration in wages, but falling import and energy prices helped to hold down price inflation over the closing months of the year.

Labor demand expanded rapidly in the fourth quarter; a sharp increase in nonfarm payroll employment in December followed large advances in October and November, and the average workweek edged up on balance over the three-month period. Job gains were widely spread across industries. In the fourth quarter, new hires in manufacturing accounted for more than half of that sector's total for the year, and construction employment also registered an unusually large rise compared with earlier in 1997. Job growth surged in retail trade and persisted at a rapid pace in service-producing industries. The civilian unemployment rate, at 4.7 percent in December, was near its low for the current economic expansion.

Industrial production continued to advance at a brisk pace in the fourth quarter. Growth in the manufacturing of durable goods remained strong despite sharply slower, though still substantial, expansion in the output of computing and office equipment. The production of nondurable goods picked up after having been sluggish earlier in the year. Capacity utilization in manufacturing was at a relatively high rate in the fourth quarter, but available information suggested few bottlenecks.

Consumer spending, in real terms, rose at a slower though still appreciable rate in the fourth quarter. Purchases of durable goods increased moderately after surging in the third quarter, and spending on nondurables edged down. By contrast, expenditures for consumer services grew at a somewhat faster rate. Recent surveys indicated that consumer confidence remained at a very high level.

Housing demand continued to exhibit considerable strength at year-end in the context of sharp declines in fixed mortgage rates in recent months, further sizable gains in employment and household income, and very positive consumer assessments of homebuying conditions. Applications for mortgages to purchase homes increased to a new monthly high in December; the pace of sales of existing homes rose further in the fourth quarter; and sales of new homes in November (latest available monthly data) were at their highest monthly pace in more than ten years. Housing starts edged lower in December but remained close to the highs of the current expansion.

After unusually strong increases earlier in the year, real business fixed investment declined slightly in the fourth quarter. However, the outlook for further growth remained positive, with corporate cash flow still healthy and the user cost of capital still low. Data on shipments of nondefense capital goods in December indicated a rebound in business spending on capital goods, notably for office, computing, and communications equipment, after sizable declines in the October-November period. Business spending on nonresidential structures declined slightly in the fourth quarter despite rising real estate prices and falling vacancy rates.

The pace of business inventory investment evidently picked up somewhat in the fourth quarter. In manufacturing, inventories climbed further in November (latest monthly data available), and the stock-shipments ratio was at the top of its narrow range for the past twelve months. The accumulation of wholesale stocks continued its strong upward trend, and by November the inventory-sales ratio for the wholesale sector had reversed its 1996 decline. In the retail sector, inventories declined slightly in November after having changed little in October; the inventory-sales ratio for this sector was near the bottom of its range for the last twelve months.

The nominal deficit on U.S. trade in goods and services narrowed substantially on average in October and November from its level in the third quarter. The value of exports rose appreciably in the October-November period, with the largest increases occurring in automotive and agricultural products. The average value of imports for October and November changed little from the third-quarter rate. Imports of consumer goods and machinery rose, but they were about offset by declines in automotive products, computers, and, to a lesser extent, a wide variety of other products. The available information indicated that economic expansion remained healthy in most of the foreign G-7 countries, although slowing somewhat from the third quarter. In Asia, weakness in economic activity in Japan continued into the fourth quarter, and persisting financial turmoil was having strong adverse effects on the economies of a number of developing countries.

Consumer price inflation remained low in December, damped by a sizable further drop in energy prices and a small decline in food prices. Excluding food and energy items, an acceleration in the costs of services, notably medical care and shelter, provided a slight boost to core consumer price inflation in December. For the year as a whole, prices of core consumer items rose considerably less than in 1996, in part reflecting the effect of declining import prices. At the producer level, prices of all finished goods and of the core finished goods component declined further in December. For the year 1997, the core producer price index was little changed after a relatively small rise the previous year; the total index, weighed down by falling prices of finished food and energy items, partially reversed its 1996 increase. Prices also remained subdued at earlier stages of processing in 1997, with prices of crude materials falling substantially. Labor costs, as measured by the hourly compensation of private industry workers, increased at appreciably faster rates in the fourth quarter and for the year.

At its meeting on December 16, 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. In light of the increased uncertainties in the outlook and the possibility that the next change in policy might be in either direction, the Committee adopted a directive that did not include a presumption about the likely direction of any adjustment to policy during the intermeeting period. 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 intermeeting period toward maintaining reserve conditions consistent with the intended federal funds rate average of around 5-1/2 percent, and the effective rate averaged close to that level despite some largely anticipated upward pressures in reserve markets around year-end. Most other domestic market interest rates moved down on balance during the intermeeting period, apparently as a result of increased concerns over the turbulence in Asia and its potential implications for the U.S. economy. Share prices in U.S. equity markets moved up slightly on net, perhaps partly in response to the bond market rally, while equity markets in some other countries, notably in Asia, remained unsettled.

In foreign exchange markets, the dollar appreciated on balance over the intermeeting period. The dollar rose considerably further against the currencies of many of the emerging market economies in Asia amid continuing market concerns about the adequacy of reforms that would be undertaken in the affected countries and the magnitude and availability of international financial assistance that would be needed to support those efforts. The dollar also gained slightly on average in relation to the currencies of the other G-10 currencies. A sizable advance by the dollar relative to the German mark was largely reversed late in the intermeeting period; incoming information suggesting greater strength in the German economy lifted the value of the mark and tended to offset growing concern about the likely effect of the Asian crisis on Germany. The dollar declined somewhat on balance against the yen as heightened prospects for domestic fiscal stimulus in Japan fostered hopes of a less weak performance of the Japanese economy.

M2 and M3 continued to grow at relatively rapid rates in December and apparently also in January. Recent gains in nominal income evidently underpinned much of the greater-than-expected strength in M2 in January; also contributing were a pickup in mortgage refinancing activity and, perhaps, depositor transfers of funds from market instruments whose yields had declined relative to those on M2 assets. Large increases in repurchase agreements contributed to rapid growth of M3 in January; the rise in M3 helped to finance further solid expansion of bank credit. From the fourth quarter of 1996 to the fourth quarter of 1997, M2 increased at a rate somewhat 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 expanded in 1997 at a pace somewhat below the middle of its range, reflecting the slow rise in the federal debt.

The staff forecast prepared for this meeting indicated that the expansion of economic activity would slow appreciably during the next few quarters and remain moderate in 1999. The staff analysis suggested that slower growth abroad and the considerable rise that already had occurred in the foreign exchange value of the dollar would exert substantial restraint on the demand for U.S. exports and subject domestic producers to even stiffer competition from imports. An anticipated reduction in the desired rate of inventory accumulation would add to the restraint on the expansion. As output growth slowed, pressures on resources would be expected to diminish somewhat. None- theless, it was expected that, consistently measured, inflation would increase to some degree over the ensuing period through 1999, owing in part to an abatement of restraining forces from foreign exchange and oil markets.

In the Committee's discussion of current and prospective economic conditions, members commented that the performance of the economy continued to be quite favorable. They noted that the economy had entered the new year with considerable momentum and very few indications that growth was moderating from what appeared to be an unsustainable rate. Nonetheless, their assessments of the various factors bearing on the outlook led them to conclude that appreciably slower economic growth was in the offing for the year ahead, possibly to a pace in the vicinity of current estimates of the economy's long- run growth potential. Many emphasized that the prospects for declining net exports as a consequence of the dollar's appreciation and the crises in a number of Asian economies were a key factor in the outlook for some slowing in the expansion. In addition, a moderating rate of inventory accumulation appeared likely after the rapid buildup during 1997. At the same time, high levels of confidence and generally accommodative financial conditions supported expectations of persisting, though likely diminishing, strength in consumer spending and business fixed investment. The members acknowledged that their forecasts were subject to a great deal of uncertainty since there was little precedent to guide them in their evaluation of the extent and likely effect of Asian market turmoil. In the circumstances, the risks of a considerable deviation on the upside or the downside of their current forecasts were unusually high. Partly as a consequence, the outlook for inflation was quite tentative as well. Moreover, questions persisted about the level and growth of sustainable output. Members observed that price inflation had remained subdued, and by some measures had declined, in recent months despite very tight labor markets and indications of somewhat faster increases in labor compensation.

In keeping with the practice at meetings just prior to the Federal Reserve's semi-annual monetary policy report to Congress and the Chairman's associated testimony, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members had provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the year ahead. Based on developments over the second half of 1997, the central tendency of the projections for 1998 now pointed to slightly more strength in real GDP and appreciably less inflation than the forecasts prepared at the time of the July 1997 meeting. The forecasts of the rate of expansion in real GDP in 1998 had a central tendency of 2 to 2-3/4 percent and a full range of 1-3/4 to 3 percent. Such growth was expected to be associated with a civilian unemployment rate in a range of 4-1/2 to 5 percent in the fourth quarter of this year, implying little or no change from the current level. With regard to nominal GDP growth in 1998, the forecasts were mainly in a range of 3-3/4 to 4-1/2 percent, with an overall range of 3-1/2 to 5 percent. Projections of the rate of inflation, as measured by the consumer price index, had a central tendency of 1-3/4 to 2-1/4 percent, on the high side of the outcome for 1997 when the rise in the index was held down by damped increases in food prices and declines in energy prices. These forecasts took account of likely further technical improvements in the CPI by the Bureau of Labor Statistics that would trim the reported rate. The projections were based on individual views concerning what would be an appropriate policy over the projection horizon to foster the Committee's longer-term goals.

The members stressed that the potential extent of the negative effects of developments in Asia on the nation's trade balance represented a key uncertainty in the economic outlook. On the whole, those effects had been quite limited thus far. Anecdotal reports indicated that a number of domestic producers, notably of agricul- tural, lumber, and wood products, had experienced some cancellations or postponements of orders from Asian customers and there was some evidence of increased imports from those nations. Exports to affected Asian nations were likely to be held back by declining incomes and rising prices of U.S. products in local currencies, and reportedly also by difficulties that importing firms in Asia were encountering in securing financing. The eventual effects of the Asian financial turmoil on the U.S. trade balance and the overall economy were unknown--in part because in some key countries needed reforms had yet to be implemented and markets to stabilize--but they clearly seemed likely to become more pronounced in coming months. Net exports also would be held down by the appreciation of the dollar against the currencies of the industrial countries that had occurred earlier in 1997 before the Asian crisis intensified.

Another factor viewed as likely to exert a moderating effect on the growth of economic activity was the expectation of some slowing in inventory investment. In the past year, businesses had added to inventories at a rate that exceeded the rise in final sales, and somewhat reduced accumulation to a pace more in line with that of final sales was seen as a reasonable expectation. Some members expressed reservations, however, about the extent of any weakening in inventory accumulation in light of the relatively favorable economic conditions that they believed were likely to persist over the year ahead.

Members viewed further growth in consumer spending as likely to remain the major factor in sustaining the expansion in overall economic activity. Consumer sentiment was at or close to historically high levels according to recent surveys, evidently reflecting the strong uptrend in employment and income and to some extent the very large cumulative increase in stock market wealth over the course of recent years. Some also noted that consumer debt burdens, while large, were manageable and that such burdens would be lessened for many consumers by their refinancing of home mortgages at the lower mortgage rates now prevailing. Evidence of strength in the consumer sector was supported by upbeat anecdotal reports of retail sales during the holiday season and more recently. While the growth in personal expenditures was likely to moderate somewhat from its recent pace, members did not rule out a more ebullient consumer sector in the context of substantial further growth in disposable incomes, favorable financing conditions for purchases of homes, automobiles, and other consumer durables, and the high level of stock market prices.

Business fixed investment also was expected to provide substantial support to continued economic expansion, though some moderation in purchases of business equipment seemed likely after the exceptionally rapid rates of growth in such investments in recent years. Business sentiment remained generally optimistic, and both debt and equity financing continued to be readily available on attractive terms to most business borrowers. However, early signs of faltering profit trends in some industries, in part related to developments in Asia, appeared to have introduced a cautionary note among some business planners. Members also referred to emerging signs of speculative overbuilding in some areas, especially of commercial structures. Even so, in the absence of unanticipated weakness in consumer expenditures, a variety of favorable factors seemed likely to sustain relatively robust spending on business structures and equipment over the year ahead. The latter included increased opportunities to cut costs and enhance efficiency by investing in relatively inexpensive high-tech equipment in a period characterized by strong competition in many markets and rising labor compensation associated with tight labor markets.

Residential construction activity had remained relatively robust in recent months and was expected to be well maintained over coming quarters. Positive indications for the housing outlook included relatively low mortgage interest rates, very favorable measures of cash-flow affordability, and quite positive home-buying attitudes as expressed in recent surveys. While these factors were expected to help sustain the housing sector over coming months, members noted that housing construction had been high for some time and some cited anecdotal evidence of softening activity in some parts of the country. On balance, only modest, if any, slippage from current levels of home construction activity seemed likely over the year ahead.

With regard to the outlook for inflation, members referred to widespread indications of increasingly tight labor markets and to statistical and anecdotal reports of faster increases in labor compensation. Labor cost increases in recent quarters had been especially rapid in a large segment of the service sector, where foreign competition was not a factor. Some members commented, however, that there were reasons to discount the sharp fourth-quarter increase in the employment cost index because to a large extent it was the result of nonrecurring developments in a limited number of industries. Despite the upward trend in labor compensation, gains in productivity clearly had kept increases in unit labor costs at a very modest level; and with unit nonlabor costs continuing to decline, overall unit cost increases had remained not far above zero. In these circumstances--and in the context of highly competitive conditions in many markets, declines in input prices and in the prices of many commodities, including oil--rising labor costs seemed to pose little risk of an upward impetus to inflation in coming months.

The longer-run outlook for inflation was more clouded and under some scenarios less promising. Inflation expectations had been moving down according to recent surveys, and in the context of relatively modest increases in consumer prices expected over coming months such expectations could continue to move lower, thereby constraining increases in compensation and prices. Nonetheless, some of the factors that had helped to moderate price increases--including declining oil prices, the appreciation of the dollar, and restrained increases in health insurance costs--were not likely to continue to exert benign effects on inflation as time went on. More fundamentally, the productivity improvement that had held down producer costs could not necessarily be counted on to continue to offset such costs, especially if the economic expansion remained sufficiently rapid to put additional pressures on available labor resources.

In keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act), the Committee reviewed the ranges for growth of the monetary and debt aggregates in 1998 that it had established on a tentative basis at its meeting in July 1997. Those ranges included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The associated range for growth of total domestic nonfinancial debt was provisionally set at 3 to 7 percent for 1998. The tentative ranges for 1998 were unchanged from the ranges that had been adopted initially for 1995 (in July of that year for M3).

In reviewing the tentative ranges, the members took note of a staff projection indicating that, given the members' expectations for the performance of the economy and prices and assuming no major changes in interest rates, M2 likely would grow in 1998 in the upper half of its tentative range, and M3 somewhat above the top of its range. The staff analysis anticipated that the velocity of M2 would continue its recent pattern of relatively stable behavior that was more in line with historical experience than had been the case in the early 1990s. The velocity of M3 was projected to continue to decline at a somewhat faster rate than historical experience would indicate, reflecting the greater use by business firms of institution-only money market funds as a cash management tool and the needs of depository institutions for appreciable non-M2 funding to finance brisk loan growth. The staff projected that the debt of the domestic nonfinancial sectors would grow around or perhaps slightly above the middle of its tentative range, reflecting the credit needs of businesses facing a weaker earnings outlook and larger merger-related retirements of equity.

In their discussion of the ranges for M2 and M3, the members noted that the apparently greater predictability of velocity in recent years could not be counted on to persist, given changes in financial markets that had made investment alternatives more readily available. As a consequence, substantial uncertainty still surrounded projections of money growth consistent with the Committee's basic objectives for monetary policy. In this environment, the members did not see any firm basis for deviating from their recent practice of setting ranges that, assuming velocity behavior in line with historical patterns, would serve as benchmarks for monetary expansion consistent with longer-run price stability and a sustainable rate of real economic growth. The tentative ranges for 1998 had been derived in this way, and Committee members saw no reason to change those ranges at this time. Indeed, adjusting the ranges to center them more closely on growth rates deemed likely to be more consistent with the Committee's expectations for economic activity and prices could foster the misinterpretation that the Committee had become much more confident of the stability and predictability of velocity and was placing greater emphasis on M2 and M3 as gauges of the thrust of monetary policy. Several members commented, however, that the adoption of ranges centered on the Committee's expectations for growth of the monetary aggregates should be reconsidered in the future if the members were to become more confident about the relationship between the growth of the money and measures of aggregate economic performance. The Committee also agreed that the range for nonfinancial debt for 1998 should be left unchanged. The tentative range readily encompassed the pace seen as likely to be associated with the members' forecasts for economic activity and prices.

Accordingly, the following statement of longer-run policy for 1998 was approved for inclusion in the domestic policy directive:

> 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 this meeting 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 1997 to the fourth quarter of 1998. The 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.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, McTeer, Meyer, and Mses. Minehan, Phillips, and Rivlin.

Votes against this action: None.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance. The economy currently was performing very well and the outlook over the near term was for subdued inflation and continued solid economic growth. Over a longer horizon, the range of possible outcomes was unusually wide, and the direction that policy would need to move to promote sustained expansion and damped inflation was unclear. At this point, the extent to which the still largely anticipated external drag from events in Asia would offset the strong upward momentum in domestic demand was a source of major uncertainty. In addition, it was impossible to predict whether or when the tightness in labor markets would exert a more pronounced effect on labor costs and ultimately on price inflation. Even the thrust of the current stance of monetary policy as it was transmitted through financial markets was open to some question. On the one hand, a real federal funds rate that was on the high side of historical experience and a substantially stronger dollar suggested some restraint. From a different perspective, however, financial conditions seemed to be quite stimulative as evidenced by lower nominal and perhaps real intermediate and long-term interest rates, rising equity prices, ready credit availability, and rapid growth of the broad measures of money and credit. While the members differed to some extent in their forecasts of major trends in the economy and in the risks of alternative outcomes, they agreed that, under foreseeable circumstances, needed adjustments to policy probably could be made on a timely basis once the balance of underlying forces became more evident. Accordingly, a steady policy would not incur an unacceptable risk of a seriously deteriorating economic performance. In the interim, the greater risk would be to make a preemptive policy move on the basis of inadequate evidence regarding underlying economic trends.

In the Committee's discussion of possible intermeeting adjustments to policy, all the members agreed that prevailing uncertainties indicated the desirability of retaining a symmetric instruction in the directive. While a number of members expressed the view that the next policy move was likely to be a tightening action and one member saw a greater probability of an easing action, the uncertainties were sufficiently great to warrant remaining sensitive to the need for a policy change in either direction. Accordingly, a symmetric directive would signal the Committee's readiness to respond promptly to developments that might threaten the economy's satisfactory performance.

At the conclusion of the Committee's discussion, all the members indicated 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, and all also favored a directive that did not include a presumption about the direction of a change, if any, in the stance of 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 members 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 during the closing months of 1997. Nonfarm payroll employment increased sharply further in December after posting very large gains in other recent months; the civilian unem ployment rate, at 4.7 percent, remained near its low for the current economic expansion. Industrial production continued to advance at a brisk pace in the fourth quarter. Consumer spending rose appreciably in the quarter, and housing starts remained close to the highs of the current expansion. Business fixed investment weakened following exceptionally strong increases in the second and third quarters; nonfarm inventory accumulation appears to have picked up somewhat. The nominal deficit on U.S. trade in goods and services narrowed significantly on average in October and November from its level in the third quarter. Price inflation has remained subdued despite appreciably faster increases in worker compensation in recent months.
>
> Most interest rates have declined on balance since the day before the Committee meeting on December 16, 1997. Share prices in U.S. equity markets have moved up somewhat over the period; equity markets in some other countries, notably in Asia, have remained volatile. In foreign exchange markets, the value of the dollar has risen over the intermeeting period relative to the currencies of several Asian developing countries, but it has registered only a small increase on average in relation to the currencies of major industrial nations.
>
> M2 and M3 continued to grow at relatively rapid rates in December and apparently also in January. From the fourth quarter of 1996 to the fourth quarter of 1997, M2 expanded at a rate somewhat 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 expanded in 1997 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 this meeting 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 1997 to the fourth quarter of 1998. The 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 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, Hoenig, Jordan, Kelley, Meyer, McTeer, Mses. Minehan, Phillips and Rivlin.

Votes against this action: None

It was agreed that the next meeting of the Committee would be held on Tuesday, March 31, 1998.

The meeting adjourned at 10:50 a.m.

Donald L. Kohn
Secretary

Return to top

Footnotes

1 Attended portions of meeting relating to the Committee's review of the economic outlook and establishment of its monetary and debt ranges for 1998.
