Minutes of the Federal Open Market Committee

March 31, 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, March 31, 1998, at 9:00 a.m.

Present:

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

Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

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

Mr. Rasdall, First Vice President, Federal Reserve Bank of Kansas City

Messrs. Goodfriend, Hunter, Kos, Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Richmond, Chicago, New York, Philadelphia, Minneapolis, and Dallas respectively

Ms. Rosenbaum, Vice President, Federal Reserve Bank of Atlanta

Mr. Rudebusch, 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 February 3-4, 1998, were approved.

The Report of Examination of the System Open Market Account, conducted by the Board's Division of Reserve Bank Operations and Payment Systems as of the close of business on November 6, 1997, was accepted.

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 February 3-4, 1998. 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 from February 4, 1998, through March 30, 1998. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that the economy continued to expand rapidly during the early months of 1998. Apparently, strong growth in private domestic spending for consump- tion, housing, and business equipment more than offset weakness in net exports and a slight moderation in inventory investment. Total employment continued to rise rapidly, but industrial production increased at a considerably slower pace. Despite indications of persisting pressures on employment costs associated with tight labor markets, price inflation abated further, primarily as a consequence of large declines in energy prices.

Nonfarm payroll employment rose sharply further in January and February. Growth in construction jobs was particularly strong, apparently reflecting in part the unseasonably warm weather across much of the country and the need to repair damage caused by ice storms and heavy rains. In addition, service industries continued to post very large employment gains. By contrast, manufacturing payrolls contracted slightly in February after a sizable increase in January. The civilian unemployment rate edged down to 4.6 percent in February, equaling its low for the current economic expansion.

Industrial production edged up on balance in January and February after having increased rapidly in the second half of 1997. Part of the deceleration stemmed from the depressing effect of unusually warm winter weather on the provision of heating services by utilities. The growth of manufacturing production also slowed considerably as a result of downward adjustments to assemblies of motor vehicles and, more generally, weakness in the output of business equipment. With investment in new manufacturing facilities still brisk and manufacturing output posting only a small advance in the January-February period, the factory operating rate eased a little.

Consumers stepped up their spending in the early months of the year; sentiment remained buoyant in the context of continued strong growth in disposable income and further gains in household wealth. Particularly large increases were recorded in expenditures on durable goods, apparel, and general merchandise. Housing demand also strengthened, with sales of existing homes reaching a record high in February and sales of new homes in January (latest data) almost equaling the previous record. Both housing starts and building permits remained on an upward trend.

Business fixed investment seemed to have rebounded from a small decline in the fourth quarter. Shipments of nondefense capital goods, notably of computing equipment whose prices continued to fall sharply, strengthened substantially in January and February. By contrast, expenditures on transportation equipment were sluggish. Despite further declines in vacancy rates and rising real estate prices, business spending on nonresidential construction also seemed to have been lackluster, with such activity not having changed much since last summer.

The pace of business inventory accumulation slowed sharply in January from the fourth-quarter rate. Some of the slowdown reflected a reduction in motor vehicle stocks; the remainder was largely associated with a drop in inventories of nondurable goods at the wholesale level. Inventory-sales ratios for most manufacturing and trade categories were within the ranges experienced over the past year.

The nominal deficit on U.S. trade in goods and services widened substantially in January from its average monthly level for the fourth quarter. The value of exports declined considerably, partly as a result of reduced exports to Asia, but the value of imports changed little. The decrease in exports was mainly in civilian aircraft and other capital goods. The available information indicated that the pace of economic expansion picked up in Europe after having slowed somewhat in the fourth quarter and was still strong on balance in Canada. Economic activity remained weak in Japan and decelerated sharply in Asian countries that had been the focus of financial turmoil.

Consumer prices were little changed on balance in January and February, as substantial declines in energy prices largely offset increases elsewhere. Excluding food and energy items, consumer price inflation picked up somewhat in the first two months of the year from the pace of the second half of 1997; on a year-over-year basis, however, the increase in consumer prices during the twelve months ended in February was slightly smaller than that in the year-earlier period. At the producer level, falling prices for finished energy goods in January and February pulled down the index of prices for all finished items; excluding food and energy, prices were unchanged on balance over the two months. Over the twelve months ended in February, producer price inflation was negligible. Tight labor markets appeared to be putting some upward pressure on labor compensation, but the pickup was limited. The change in average hourly earnings over the twelve months ended in February was only slightly larger than the increase over the year-earlier period.

With economic growth still solid and inflation subdued, the Committee at its meeting on February 3-4, 1998, had adopted a directive that called for maintaining conditions in reserve markets that would be consistent with an unchanged federal funds rate of about 5-1/2 percent. The substantial uncertainties about the future strength of economic activity and inflation suggested that the next change in policy could be in either direction, and the Committee also had agreed that the directive should not contain a presumption about the direction of any change in the stance of policy during the intermeeting period. The 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 for the federal funds rate of around 5-1/2 percent, and the rate fluctuated in a narrow range around that level. By contrast, interest rates in other domestic financial markets generally rose somewhat on balance over the period in response to incoming information that suggested aggregate private demand remained robust. Despite the rise in rates and some erosion in the outlook for near-term corporate profits, share prices in U.S. equity markets moved up substantially further.

In foreign exchange markets, the dollar appreciated somewhat on balance over the intermeeting period in relation to the currencies of the other major industrial countries. Against a background of weakening growth in Japan and continued uncertainty about the prospects for fiscal stimulus in that country, the dollar rose considerably against the yen. The dollar changed little against the mark and other continental European currencies but declined against the Canadian dollar and the British pound. The dollar also depreciated significantly relative to the currencies of several emerging market economies in Asia, reflecting market assessments that progress had been made in reforming economic policies and financial and commercial practices in most of those countries.

The available information for February and part of March indicated that M2 and M3 expanded more rapidly than the Committee had anticipated at the time of its February meeting. On a quarterly average basis, growth of both monetary aggregates picked up somewhat in the first quarter from already robust rates in the fourth quarter. The increased demand for M2 was perhaps associated in part with the reduced attractiveness of longer-term fixed rate market assets, whose yields had declined significantly relative to the returns on liquid investment components of M2. In addition, households might have been trying to rebalance asset portfolios that had become more heavily weighted in equities as a result of the run-up in stock prices. The pickup in M3 growth reflected a surge in bank issuance of large time deposits to finance strong demands for loans by businesses and households. The expansion of total domestic nonfinancial debt also strengthened over recent months in response to heavy private demands for credit.

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 the surge in household net worth over the past several years would help to support sizable, though gradually diminishing, gains in consumer spending; favorable cash flow affordability would underpin housing demand at a relatively high level; and substantial increases in capital spending would persist until slower growth in business sales and weaker profits began to have a restraining effect in 1999. Reduced growth of foreign economic activity and the lagged effects of the considerable rise that had occurred in the foreign exchange value of the dollar were expected to exert substantial restraint on the demand for U.S. exports over the projection period and to increase the pressures on domestic producers that face import competition. An anticipated slowdown in the pace of inventory accumulation also would restrain domestic production as stocks were brought into balance with the expected lower trajectory for sales. Although pressures on production resources would abate to a degree as output growth slowed, inflation was expected to increase somewhat in response to persisting tightness in labor markets and a diminishing drag from non-oil import prices.

In the Committee's discussion of current and prospective developments, members commented on the persistence of unusually favorable economic conditions, characterized by strong growth and low inflation, but a number questioned how long these conditions might last without a policy adjustment. Domestic demand was exceeding expectations and was likely to continue to increase rapidly for some time, supported by accommodative conditions in key segments of financial markets. Developments in foreign trade were moderating demands on domestic resources; but with domestic spending strong, members were becoming more concerned that those developments might not exert enough restraint on aggregate demand to slow the expansion to a sustainable pace in line with the growth of the economy's potential. Despite tightening labor markets, inflation prospects remained quite favorable for a while as a number of factors--some temporary--helped to damp near-term pressures on prices. Nonetheless, in the absence of some slowing in the expansion, labor compensation probably would continue to accelerate and increasingly outpace productivity, adding to pressures on prices.

In their review of the outlook for spending in key sectors of the domestic economy, members saw little reason to anticipate substantial slowing in the growth of consumer or business expenditures in coming quarters, and they also expected housing activity to be maintained at a relatively high level. The recent further increases in equity prices from already high levels played an important role in the assessments of several members. The stock market's rise was viewed as somewhat puzzling, given indications of some slowing in the growth of profits and the potential for earnings disappointments as the expansion in spending moderated and profit margins narrowed in the context of more rapid labor cost increases. So long as a high degree of optimism in the stock market persisted, however, the elevated level of financial wealth and the low cost of capital should continue to boost spending. Consumer expenditures, especially for durable goods, had risen sharply thus far this year, and the factors that had fueled that expansion were still unusually positive. They included large increases in employment and personal incomes, the continuing uptrend in financial wealth relative to disposable income, and, in these circumstances, the persistence of a very high level of consumer confidence. Attractive financing conditions and favorable business confidence also were expected to support substantial further growth in business investment, especially in "high-tech" equipment that was characterized by rapid product improvement and falling prices. Investment in nonresidential structures, notably in office and other commercial markets, seemed likely to strengthen somewhat in response to reduced vacancy rates and sizable increases in rents in many areas; indeed, several members again reported indications of speculative nonresidential construction in some parts of the country. Residential construction was expected to be maintained at a high level, though single-family starts might soften over the next few months after a surge that appeared to have been related to relatively favorable weather conditions during the winter. With mortgage rates at their recent reduced levels and incomes continuing to rise, the cash flow affordability of home ownership was exceptionally favorable.

Developments in two areas of expenditures were thought likely to exert some restraining effect on the overall expansion in economic activity over coming quarters. One was business inventory accumula- tion, which had exceeded the robust growth in final sales in 1997 and probably would moderate this year as business firms sought to restrain the buildup in their inventories to keep them in better alignment with the expected moderation of gains in sales.

The second, foreign trade developments, also was likely to have a damping influence on the domestic economy. While the lagged effects of the dollar's appreciation and economic conditions in key U.S. trading partners around the world were important factors in this assessment, members focused in this discussion on the effects of weakness in several Asian economies. Conditions in Japan and in key emerging market economies in Asia were still quite fragile, adjust- ments on the real side of the economy were just beginning to be felt in some cases, and outcomes for economic growth and exchange rates were still very much in doubt. Nonetheless, some progress had been made in putting recovery programs together and financial markets had seemed to stabilize in several countries. Anecdotal reports of adverse repercussions on individual U.S. firms from the Asian financial turmoil had increased somewhat since the Committee's previous meeting, but the direct overall impact on the U.S. economy was still limited. Indeed, developments in Asia also appeared to have had positive, albeit indirect, effects on domestic demand and prices in the near term by exerting some downward pressure on U.S. interest rates and world oil prices. Prices in the United States of a number of Asian goods and of domestic products competing with those goods had been lowered. Over time, conditions in key Asian economies were thought likely to have a more pronounced retarding effect on the U.S. economy. While the eventual dimensions of that effect remained uncertain, a number of members commented that, on the basis of developments to date, they might turn out to be less negative than had been expected earlier, or at least that some "worst case" outcomes seemed less likely.

With regard to the outlook for inflation, members observed that price inflation remained quite low--in fact, it was still declining by some measures--and there was little evidence of any potential acceleration in current price data or in anecdotal reports from around the country. Nonetheless, as they had at previous meetings, members expressed particular concern about the outlook for prices in the absence of appreciable slowing in the growth of aggregate demand, which appeared to be adding to pressures on labor resources. Anecdotal reports from across the nation continued to suggest exceptionally tight labor markets and growing indications of somewhat faster increases in labor compensation. To date, unit labor costs had been contained by large capital investments and other initiatives that had raised the productivity of labor. But additional improvements in productivity growth could not be counted on to offset further increases in the rate of growth of labor compensation, which were more likely to occur especially if labor markets were to tighten further. Moreover, the effects of a number of special factors that had tended to limit cost pressures and price inflation in recent years were not likely to persist; these included the declines in world oil prices, the subdued increases in the costs of health benefits, and the lagged effects of the appreciation of the dollar. To be sure, the factors that had produced the favorable inflation results of recent years were not all well understood, and consequently expectations of greater price pressures had to be tentative. On balance, though any upsurge in inflation seemed unlikely in the nearer term, the risk that inflation might move higher over the longer run seemed to have increased.

Despite perceptions of a greater risk of rising inflation over time, all but one of the members indicated in the Committee's policy discussion that they preferred or could accept a proposal to maintain an unchanged policy stance that also included a shift from the current symmetrical directive to an asymmetrical directive tilted toward restraint. The members agreed that should the strength of the economic expansion and the firming of labor markets persist, policy tightening likely would be needed at some point to head off imbalances that over time would undermine the expansion in economic activity. Most saw little urgency to tighten policy at this meeting, however. The economy might well continue to accommodate relatively robust economic growth and a high level of resource use for an extended period without a rise in inflation. Some members noted that price increases would be held down for a while by the effects of the higher dollar, which had not worked their way fully through domestic prices. Moreover, inflation continued to fall by some measures and inflation expectations still seemed to be adjusting downward toward actual inflation; further declines in these expectations would restrain increases in compensation and prices. Members also noted that the ultimate extent of retarding effects from the financial turmoil in Asia was still uncertain, and several cited the possibility of a downward adjustment in the stock market, perhaps in response to disappointing growth in business profits, that could have an adverse impact on business and consumer confidence. In these circumstances, a preemptive policy move to head off rising inflation could prove premature or perhaps even unwarranted; indeed, in the view of some, a tightening move was not inevitable. Moreover, because a policy action was not currently anticipated, some commented that a tightening could produce an outsized and undesirable response in financial markets. On balance, in light of the uncertainties in the outlook and given that a variety of special factors would continue to contain inflation for a time, the Committee could await further developments bearing on the strength of inflationary pressures without incurring a significant risk that disruptive policy actions would be needed later in response to an upturn in inflation and inflation expectations.

One member indicated a strong preference for an immediate policy tightening move, largely on the grounds that under current conditions relatively rapid growth in money and credit was not consistent with continued progress toward reducing inflation. A number of other members also commented that the strength of the monetary aggregates, especially if it should persist, was suggesting ample liquidity and accommodative financial conditions. In addition, some cited ebullient equity markets and narrow risk spreads in credit markets as additional evidence that financial conditions were not restraining final demands very much. These were factors that they would weigh in their evaluation of the need for, and timing of, a policy tightening move.

The members agreed that they should be particularly sensitive to developments that might signal rising inflation pressures, and in that regard a shift to an asymmetric directive seemed desirable. Such a directive would be consistent with the Committee's judgment that the information that had become available since a symmetric directive was last adopted in February had altered the inflation risks enough to make some tightening a likely prospect in the not too distant future. In that regard several suggested that the need for some policy tightening could well materialize in the near future.

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 contained a bias toward the possible firming of reserve conditions and a higher federal funds rate. 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 considerable moderation in the growth in M2 and M3 over the months ahead.

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 early months of 1998. Nonfarm payroll employment increased sharply further in January and February, and the civilian unemployment rate, at 4.6 percent in February, equaled its low for the current economic expansion. However, growth in manufacturing payroll employment was down over the first two months of the year, and factory output decelerated appreciably. Consumer spending has risen considerably further since year-end, and housing activity also has strengthened in recent months. Available indicators point to a sharp rebound in business fixed investment following a small decline in the fourth quarter. Fragmentary data on nonfarm inventories suggest a slower rate of accumulation early in the year. The nominal deficit on U.S. trade in goods and services widened substantially in January from its average monthly rate in the fourth quarter. Despite indications of persisting pressures on employment costs associated with tight labor markets, price inflation has abated further, primarily as a consequence of large declines in energy prices.
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> Interest rates generally have risen somewhat on balance over the intermeeting period. Share prices in U.S. equity markets have moved up substantially further over the period. In foreign exchange markets, the value of the dollar has increased somewhat over the period in relation to the currencies of other major industrial nations, but it has depreciated relative to the currencies of most emerging market economies in Asia.
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> Growth of M2 and M3 picked up somewhat in the first quarter from already robust rates in the fourth quarter. Expansion of total domestic nonfinancial debt also has strengthened over recent months.
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> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic non- financial 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 develop- ments in the economy and financial markets.
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> 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 considerable modera- tion in the growth in M2 and M3 over coming months.
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> **Votes for this action:** Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Mses. Minehan, Phillips, Mr. Poole, and Ms. Rivlin.
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> **Votes against this action:** Mr. Jordan.

Mr. Jordan dissented because growth rates of various measures of money and credit in the second half of 1997 and the first quarter of this year were not consistent in his view with continued progress in reducing inflation. Recent price statistics understated the trend rates of inflation. The one-time effects of falling oil prices, lower food prices, and recent appreciation of the dollar on foreign-exchange markets provided only a temporary reduction of inflation. While some reacceleration of reported rates of inflation was probably unavoidable, sustained rapid money growth would risk even higher inflation in future years. The durability of the economic expansion would be jeopardized by price and wage decisions reflecting expectations that the purchasing power of the dollar would decline at faster rates in the future. Once such expectations became imbedded in the economy, even stronger policy actions would be required in order to reestablish a downward trend of inflation.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 19, 1998.

The meeting adjourned at 1:05 p.m.

Donald L. Kohn
Secretary