Minutes of the Federal Open Market Committee

August 18, 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, August 18, 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
Mr. Poole
Ms. Rivlin

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

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

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Cecchetti, Dewald, Hakkio, Lindsey, 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

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

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

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Struckmeyer, Assistant Director, Division of Research and Statistics, Board of Governors

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

Ms. Strand and Mr. Varvel, First Vice Presidents, Federal Reserve Banks of Minneapolis and Richmond respectively

Messrs. Beebe, Goodfriend, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, and Dallas respectively

Messrs. Bolwell, King, Kopcke, Meyer, and Sullivan, Vice Presidents, Federal Reserve Banks of New York, Atlanta, Boston, Philadelphia, and Chicago respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

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By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 30-July 1, 1998, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets during the period since the previous meeting. There were no open market operations in foreign currencies for the System's 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 July 1, 1998, through August 17, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that domestic final demand continued to expand at a robust pace. However, increases in consumer spending and business investment seemed to be moderating somewhat after very large gains earlier in the year, and inventory investment had slowed markedly. Net exports remained weak as a result of the persisting turmoil in Asian economies. The strike at General Motors had damped overall economic activity temporarily, but total payroll employment continued to trend upward, and labor markets remained extremely tight. Despite the pressures on labor resources, trends in wages and prices had remained stable in recent months.

Nonfarm payroll employment expanded further in July even though manufacturing payrolls plunged in association with the General Motors strike; job growth remained strong in most non-manufacturing sectors. Construction employment continued to increase at about the brisk pace recorded over the first half of the year, and hiring in retail trade surged. The expansion of jobs in the services industry slowed considerably in July, but this partly reflected a decline in temporary help jobs related to the GM strike. The civilian unemployment rate was unchanged in July at 4.5 percent.

Industrial production declined considerably in June and July. Abstracting from the effects of the GM strike, manufacturing output fell slightly over the June-July period after having recorded moderate gains on average in earlier months of the year; production of business equipment expanded briskly in June and July, while the output of consumer goods and materials weakened. The rate of utilization of manufacturing capacity was down appreciably in June and July, mostly reflecting the effects of the GM strike.

Total nominal retail sales fell in July after having risen at a rapid pace in the first half of the year. A sharp contraction in spending for motor vehicles, reflecting the termination at midyear of sales incentives offered by the Big Three automakers and shrinking inventories at GM dealers, more than accounted for the drop in July. Non-auto-related outlays continued on a robust upward trend, with gains evident in all major categories. Sales increases were particularly large at furniture and appliance stores and apparel outlets. In the housing sector, both demand and construction activity remained strong. Starts of single-family units edged down in May but rebounded in June. Sales of new homes were at an all-time high in June, and sales of existing homes were only a little below the record level reached in March of this year. With sales robust, the inventory of unsold new homes remained low.

Growth of business fixed investment slowed in the second quarter as the pace of business spending for durable equipment moderated considerably from the exceptionally strong rate of earlier in the year. Nonetheless, outlays for computer and communications equipment continued to expand rapidly in the second quarter, and purchases of other capital goods rose briskly. Available information suggested that growth in business spending on capital goods likely would slow further in the months ahead. In contrast to the strength in equipment spending, expenditures on nonresidential building declined further in the second quarter, and available indicators pointed to a mixed outlook for this sector in coming months.

Business inventory investment slowed sharply in the second quarter, owing in substantial measure to a runoff of motor vehicle inventories at the wholesale and retail levels. In manufacturing, stockbuilding slowed somewhat in the second quarter, and the stock-shipments ratio at the end of the quarter remained close to the low level that had prevailed over the past year. Wholesale inventories changed little on balance in the second quarter as a sizable decline in motor vehicle stocks offset a buildup of non-auto durable goods; in June, the aggregate inventory-sales ratio for this sector was at the upper end of its narrow range for the past year. At the retail level, a drop in inventories of motor vehicles in the second quarter more than offset a small increase in stocks at non-auto retailers, and the aggregate inventory-sales ratio in June was a little below the lower end of its range for the past year.

The nominal deficit on U.S. trade in goods and services widened substantially further in the second quarter; the value of exports of goods and services declined for a second straight quarter, while the value of imports continued to rise, though at a somewhat reduced pace. Much of the decline in exports in the second quarter was in capital goods, but there also were noticeable decreases in most other major trade categories. The increase in imports was concentrated in imported consumer goods, aircraft, and steel. Economic activity in most of the major foreign industrial countries continued to expand, though at a slower rate, in the second quarter. In Japan, however, economic activity appeared to have contracted sharply further in the second quarter. In most other Asian economies, currencies and equity prices were under downward pressure, and in Russia, asset values plummeted in often disorderly markets. Risk spreads on dollar-denominated debt widened substantially, not only in Russia but for Latin American issuers as well.

Price and wage inflation had remained relatively stable in recent months. Both the overall CPI and the CPI excluding food and energy items rose slightly on balance in June and July; a small rise in food prices offset a noticeable decline in energy prices over the two-month period. For the twelve months ended in July, the core CPI registered a slightly smaller increase than it had in the year-earlier period, partly reflecting lower prices for new motor vehicles. Producer prices of finished goods changed little on balance in June and July; a sizable drop in the prices of energy products over the June-July period more than offset a modest rise in core producer prices. For the year ended in July, core producer prices rose somewhat more than in the year-earlier period, reflecting larger increases in the prices of finished consumer goods. Hourly compensation of private industry workers rose in the second quarter at about the average rate for the previous two quarters. For the year ended in June, however, hourly compensation picked up significantly from the year-earlier period; the acceleration in compensation was evident in wages and salaries and in benefits.

At its meeting on June 30-July 1, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that would be consistent with the federal funds rate continuing to average around 5-1/2 percent. With the balance of risks still pointing to the possibility of rising inflation over time, the Committee chose to retain an asymmetric directive tilted toward a possible firming of reserve conditions and a higher federal funds rate. The reserve conditions associated with this directive were expected to be consistent with moderate growth in M2 and M3 over the months ahead.

Open market operations were directed throughout the period since the meeting on June 30-July 1 toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate averaged a little above the intended level of 5-1/2 percent. Most other interest rates fell slightly on balance over the intermeeting period in response to market assessments that worsening conditions in Asia, Latin America, and Russia portended slower growth in U.S. output and inflation over an extended period ahead. Declines in Treasury yields also reflected a continuing flight toward safety and quality from the persisting turbulence in foreign markets. In an atmosphere of increasing concerns about the prospects for corporate earnings, share prices in U.S. equity markets remained volatile and major indexes declined appreciably on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar rose somewhat further over the intermeeting period in relation to other major currencies. The dollar changed little against the continental European currencies but it moved up strongly against the Japanese yen and, to a lesser extent, the Canadian dollar. The dollar's rise in terms of the yen reflected spreading pessimism regarding the Japanese government's ability to redress the problems of its troubled banking system and provide fiscal stimulus adequate to turn its economy around. The dollar's advance against the Canadian dollar occurred in the context of continuing weakness in global commodity prices that was weighing down that currency. The dollar also appreciated slightly in terms of an index of the currencies of the developing countries of Latin America and Asia that are important trading partners of the United States.

After having expanded briskly in the second quarter, M2 grew at a somewhat more moderate

rate in July, and M3 changed little. The deceleration in M2 reflected reduced inflows to retail money market funds. The halt in the growth of M3 was associated with a sharp runoff of large time deposits and outflows from institution-only money market funds triggered by a temporary spike in interest rates on market instruments around quarter-end. For the year through July, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appeared to have moderated somewhat in recent months after a pickup earlier in the year.

The staff forecast prepared for this meeting indicated that economic activity would expand through 1999 at a pace somewhat below the estimated growth of the economy's potential. Reduced growth of foreign economic activity and the lagged effects of the sizable earlier rise in the foreign exchange value of the dollar were anticipated to place substantial restraint on the demand for U.S. exports and to lead to further substitution of imports for domestic products. Moreover, additional moderation in business inventory investment would damp domestic production as inventory accumulation was brought into better balance with the forecast of a more moderate trajectory of final sales. The staff analysis suggested that the prospective gains in income coupled with the earlier run-up in household wealth would support further brisk, though gradually diminishing, gains in consumer spending. Housing demand was expected to remain relatively strong in the context of the persisting favorable cash flow affordability of home ownership, though the slower income growth anticipated over the projection period would damp homebuilding somewhat. Growth in business fixed investment would gradually moderate from the vigorous pace of the first half of the year in response to smaller increases in business sales and profits. Pressures on labor resources were likely to diminish somewhat as the expansion of economic activity slowed, but inflation was expected to pick up gradually as a result of an anticipated reversal of some of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic conditions, members focused on the disparate forces that continued to shape trends in economic activity, notably the persist- ence of considerable strength in private domestic spending and the damping influences stemming from foreign economic developments. The latter seemed likely to be larger than previously anticipated as financial turmoil in some foreign economies had deepened and spread and currently showed few signs of stabilizing. Moreover, equity prices and risk spreads in U.S. financial markets were beginning to be adversely affected, potentially slowing domestic demand. The members generally anticipated somewhat more moderate growth than they had in their previous forecasts, with prospective expansion at a pace near or somewhat below the growth of economy's potential. Nonetheless, they remained concerned about the potential for higher inflation, given the widespread tightness in labor markets and an upward tilt in the rise of labor compensation. For the present, however, inflation remained subdued, and it was likely to remain relatively low for some time in light of the weakness in commodity and other import prices and the tendency for low current inflation to hold down expected price increases.

Among the factors bearing on the outlook for domestic economic activity, the members viewed the external sector as a major source of uncertainty. The continued rapid decline in net exports during the first half of the year largely seemed to reflect the further financial unsettlement and a deeper contraction in Asian economies than had been anticipated earlier, and several members commented that they saw little evidence that financial and economic conditions in Asia were stabilizing. Indeed, such conditions appeared to be worsening further in some Asian nations, and other countries had been affected by the associated weakening in the demand for commodities and the more risk-averse attitudes of investors. Anecdotal reports at this meeting suggested that the impact on the domestic economy was being felt by manufacturing firms in several industries, although some firms also reported that declining exports to Asia were being offset at least in part by rising exports to other areas of the world. Looking ahead, the members agreed that the duration and extent of disruptions in Asian and other economies could not be anticipated with any degree of confidence; while net exports were not expected to decline as rapidly as they had in the first half of the year, even more serious disruptions in Asia could not be ruled out and would have important implications for the U.S. economy.

In their review of developments in key expenditure sectors of the domestic economy, members observed that over the first half of the year the strength in domestic final demand, notably in the consumer and business investment sectors, had more than offset the negative effects of developments in the foreign sector and other factors. In the consumer sector, the outlook for further sizable increases in spending was buttressed by unusually favorable underlying factors, including solid ongoing gains in employment and incomes and substantial further increases in household net worth this year. A pause in the robust gains in retail sales in early summer was accounted for in part by limited inventories of new motor vehicles associated with the now-settled GM strike. While a variety of factors pointed to sustained growth in consumer spending, a less ebullient stock market, should it persist, would foster more moderate expansion in consumer spending, perhaps at a pace more in line with the rise in consumer incomes, or at an even slower pace if consumer confidence were adversely affected by developments in financial markets.

Business fixed investment also seemed to be on a solid upward trajectory, though some slowing in the growth of business investment spending was anticipated in response to a projected deceleration in overall business output and weaker business profits. Members continued to cite anecdotal evidence of very strong construction activity in many parts of the country, including indications that building projects were being delayed because of shortages of labor and some construction materials. In other parts of the country, building activity remained at a high level but seemed to have moderated somewhat. Business spending for various types of high-tech equipment had surged to an undoubtedly unsustainable pace in the first half of the year. Against this background, several members referred to emerging signs of slightly more cautious attitudes among their business contacts, in many cases the result of concerns about developments in Asia. On balance, diminishing momentum in business investment appeared to be a likely prospect, but the ample availability of financing on favorable terms would continue to support this sector.

In the housing sector, construction activity remained at a high level in most parts of the nation and, as was the case for construction activity more generally, homebuilding continued to be restrained in a number of areas by limits on the availability of labor and other inputs. The housing market clearly was benefiting from strong gains in household incomes, high levels of household wealth, and very attractive financing costs. There were few indications of any moderation in this sector of the economy. Even so, some slowing was anticipated, at least after current construction backlogs were satisfied, in response to the projected slowing in employment growth and the high level of the housing stock.

Currently available data indicated that the pace of inventory accumulation had moderated substantially in the second quarter. Nonetheless, the rate of non-auto inventory investment in the spring still appeared to have exceeded a pace that was consistent with sustainable growth in sales. Anecdotal reports at this meeting pointed to a somewhat mixed picture with regard to desired inventory levels, including examples of both overstocking and shortages. Looking ahead and apart from short-run fluctuations, inventories were not expected to add to demand over coming quarters, at least after the restocking of motor vehicles by General Motors was completed.

In the Committee's discussion of the outlook for wages and prices, members commented that the rate of inflation in consumer prices was difficult to characterize with precision because alterna- tive price indexes provided different measurement results; in particular, chain price indexes for consumption expenditures showed substantially less inflation than the CPI. Even so, it was clear on the basis of any measure that consumer prices and inflation more generally had remained remarkably subdued in the context of very tight labor markets and upward pressure on labor compensation. And whatever the explanation, it seemed that the economy had been less prone to rising inflation than it had been historically under similarly tight labor market conditions. The members acknowledged that a number of special factors were contributing to the relatively benign inflation climate. Those factors included the appreciation of the dollar; declines in many commodity prices, notably that of oil; ample industrial capacity; and evidently diminished inflation expectations. Moreover, substantial gains in productivity were muting the effects of rising labor compensation on unit costs, and vigorous competition in numerous markets was continuing to make it very difficult or impossible for business firms to raise their prices to cover rising costs or enhance profit margins. Against this backdrop, members remained persuaded that a significant rise in price inflation was not likely to occur in the nearer term.

Looking further ahead, however, the members generally agreed that rising price inflation remained an important threat. Significant additional tightening in labor markets would, of course, exacerbate that risk, but even at current levels these markets were tight and at some point labor costs could increase more rapidly, pressing on prices. Moreover, the effects of some of the factors holding down inflation seemed likely to wane, and possibly to reverse, over time. The latter included the effects of the dollar's appreciation on the prices of imports and competing domestic products, a possible upturn in energy prices and perhaps other commodity prices as foreign economies stabilized, and faster increases in the costs of worker benefits, notably those related to health care. The apparently greater willingness of labor unions to press for higher wages and other benefits in very tight labor markets might also intensify upward pressures on labor costs. On balance, while the risks of an overheat- ing economy and rising price inflation might have faded to some degree, many of the members continued to emphasize that the Committee could not ignore those risks in its policy formulation.

In the Committee's discussion of policy for the intermeeting period ahead, all but one of the members agreed on the desirability of maintaining a steady policy stance. The overall performance of the economy remained highly satisfactory. While inflation risks were still a concern, given the high level of output and strong domestic demand, the uncertainties bearing on the economic outlook remained substantial, and indeed the risks on the downside seemed to have increased appreciably further. On balance, domestic economic and financial conditions had not changed sufficiently during the inter- meeting period to warrant an adjustment to policy. With regard to the current uncertainties in the economic outlook, members emphasized that the extent and ultimate effects of the apparently spreading fragility in foreign financial markets and economies on U.S. financial and economic conditions were unknown. In these circumstances, nearly all the members believed that a cautious wait-and-see approach to policy seemed appropriate to allow the Committee time to assess the course of events and the interplay of the divergent forces bearing on the performance of the economy. In this regard it was noted that while domestic financial conditions remained generally accommodative, recent developments in foreign exchange and domestic financial markets had tended on balance to decrease some of the stimulative effects of financial conditions on aggregate demand in the United States by shifting demand overseas, increasing somewhat the cost of raising capital, and reducing the financial wealth of households. However, a few members expressed concern about the potentially inflationary implications of relatively rapid growth in key monetary aggregates over the past year, though such growth appeared to have moderated recently. And in the view of one of these members, the trend in monetary growth along with indications of rising speculative imbalances and excesses in various markets for financial and nonfinancial assets called for a prompt firming of monetary policy.

While overall economic conditions had not changed enough in recent weeks to warrant an adjustment in policy, a majority of the members agreed that the risks to the economic outlook were now more balanced and called for a shift from asymmetry to symmetry in the Committee's directive. Such a directive would better represent their view that the Committee's next policy move could be in either direction depending on developments abroad and their interaction with a domestic economy that had remained quite strong. Greater difficulties abroad and associated downward pressures on demand and prices had substantially diminished the chances of a strengthening of inflation pressures over coming months and quarters that would require a near-term tightening of policy. Other members continued to believe that the risks were still tilted to some degree toward rising inflation, though to a lesser extent than earlier. Labor market developments continued to suggest that the economy could well be producing beyond its sustainable potential and concrete signs that inflation pressures would abate had yet to emerge. Accordingly, they still preferred an asymmetrical directive but could accept symmetry in light of the prevailing uncertainties in the economic outlook and the expectation, shared by the other members, that policy would not need to be changed during the intermeeting period ahead.

At the conclusion of the Committee's discussion, all but one of the members were in favor of retaining 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. Most also indicated that they could support a shift to a directive that did not include a presumption about the likely direction of any adjustments 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 slightly greater or slightly lesser reserve restraint would be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth in M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The information reviewed at this meeting suggests that domestic final demand

has continued to expand at a robust pace, but overall economic activity has been adversely affected by the strike at General Motors and developments in Asia. Nonfarm payroll employment continued to expand through July and the civilian unemployment rate was unchanged at 4.5 percent. Industrial production declined considerably in June and July; most of the drop over the two months reflected the GM strike. A decline in total retail sales in July was more than accounted for by a sharp contraction in spending for motor vehicles. Residential sales and construction have remained exceptionally strong in recent months. Available indicators point to continued growth in business capital spending, although apparently at a more moderate pace than earlier in the year. Business inventory accumulation slowed sharply in the spring. The nominal deficit on U.S. trade in goods and services widened substantially further in the second quarter. Trends in wages and prices have remained stable in recent months.

Most interest rates have fallen slightly on balance since the meeting on June 30-July 1. Share prices in U.S. equity markets have remained volatile and major indexes have declined appreciably on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar rose somewhat further over the intermeeting period in relation to other major currencies; in addition, it was up slightly in terms of an index of the currencies of the developing countries of Latin America and Asia that are important trading partners of the United States.

After robust growth in the second quarter, M2 decelerated somewhat and M3 was about unchanged in July. For the year through July, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appears to have moderated somewhat in recent months after a pickup earlier in the year.

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 reaffirmed at its meeting on June 30-July 1 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 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. 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 consider- ation to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate would be acceptable in the inter- meeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin.

Vote against this action: Mr. Jordan.

Mr. Jordan dissented because he believed that the underlying strength of aggregate demand in the U.S. economy would remain fundamentally intact, despite economic problems abroad. The problems in Asia provide a channel for economic imbalances to develop. Exports from some U.S. manufacturing industries will decline due to softer foreign markets and import competition. At the same time, domestic demand for imports, housing, and consumer durables will increase due to favorable interest rate trends. Though U.S. production of goods and services might slow during the period ahead, it is not yet clear that total demand will diminish at a comparable pace. At the same time, ample credit provision encourages speculative lending and excessive consumption. Consequently, continued rapid growth in the money supply creates the risk that inflation will accelerate and economic imbalances will become protracted.

TELEPHONE CONFERENCE

On September 21 the Committee held a telephone conference to discuss recent developments in domestic and international financial markets and their implications for the U.S. economy. The consultation was held as background for Chairman Greenspan's testimony on September 23 before the Senate Budget Committee.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 29, 1998.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary