Minutes of the Federal Open Market Committee

December 22, 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, December 22, 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. 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
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist

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

Mr. Fisher, Manager, System Open Market Account

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

Ms. Johnson, Director, Division of International Finance, Board of Governors

Messrs. Alexander and Hooper, Deputy Directors, Division of International Finance, Board of Governors

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

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

Governors

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

Ms. Pianalto, First Vice President, Federal Reserve Bank of Cleveland

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lang, and Rolnick, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Chicago, Philadelphia, and Minneapolis respectively

Mr. Gavin and Ms. Perelmuter, Vice Presidents, Federal Reserve Banks of St. Louis and New York respectively

Mr. Duca, Assistant Vice President, Federal Reserve Bank of Dallas

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By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 17, 1998, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting, and thus no vote was required of the Committee.

By unanimous vote the Committee amended the Authorization for Foreign Currency Operations to add the euro to the list of foreign currencies in which the Federal Reserve Bank of New York is authorized to conduct open market operations. The Desk's holdings of German marks will automatically be converted to euros when that currency is introduced on January 1, 1999.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period November 17, 1998, through December 21, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to 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 the economy had continued to expand at a brisk pace in recent months. Domestic final demand had remained robust, and production and employment had recorded further solid gains. Trends in various measures of wages and prices had been mixed in recent months.

Nonfarm payroll employment rose strongly in November after recording reduced increases in September and October. Job gains were widespread in November; hiring in the services industries remained brisk, construction payrolls surged further, and retail employment rebounded after a lackluster rise in October. In sharp contrast to the general job picture, employment in manufacturing continued to drop. The civilian unemployment rate fell to 4.4 percent in November.

Total industrial production declined somewhat in November in association with a weather-related drop in utilities output and persisting weakness in mining activity. Manufacturing output was unchanged in November after a considerable increase in October. Production in high-tech industries recorded large gains over the October-November period, the output of construction supplies climbed rapidly, and consumer goods manufacture expanded briskly. Elsewhere, production of motor vehicles and parts was unchanged on balance over the two months and materials output continued to decline, with the iron and steel industry registering particularly large decreases. The utilization of manufacturing capacity dropped over the October- November period to its lowest level in more than five years.

Strength in consumer spending persisted in October and November, with retail sales rising sharply in both months. Increases in sales of motor vehicles and other durable goods were particularly large, but expenditures for nondurable goods also recorded sizable advances. Supported by continuing gains in disposable income and the rebound in the stock market, consumer confidence remained at a relatively favorable level, though noticeably below the peak reached earlier in the year.

The residential housing sector continued to surge, as single- family housing starts registered another strong advance in November and sales of new homes remained at a very high level. Unseasonably favorable weather over much of the country evidently contributed to that performance. Nonetheless, the low level of mortgage rates and a record high in an index of consumer assessments of homebuying conditions in November suggested that strength in single-family housing might continue for a time. Multifamily housing starts in October and November were slightly above the average for earlier in the year, and permits for new projects had been rising recently.

Business fixed investment appeared to have rebounded from a small decrease in the third quarter that had been associated in part with a strike-related drop in business purchases of motor vehicles and persisting weakness in nonresidential construction. Shipments of office and computing equipment rose sharply in October after having declined for two months, and a sizable backlog of orders for communications equipment suggested that the downturn in shipments in October after a September surge would be shortlived. In addition, outlays for heavy trucks reached record levels and expenditures for aircraft were well maintained. In the nonresidential sector, building activity remained soft in October. Office construction picked up further in response to falling vacancy rates and rising rental costs, but other building activity continued sluggish, and available data on new contracts pointed to persisting weakness.

Business inventory accumulation slowed appreciably in October after a sizable rise in the third quarter. In manufacturing, however, the pace of stockbuilding picked up in October from a slow rate in the third quarter, and the stock-shipments ratio remained in the upper portion of its narrow range over the past year. In the wholesale sector, inventories declined somewhat in October following a large increase in the third quarter; much of the reduction was in farm products. The inventory-sales ratio for the wholesale sector was still at the top of its range over the past year. Retail inventory accumulation in October was near the modest pace of the third quarter, and the inventory-sales ratio was slightly below its range over the preceding twelve months.

The nominal deficit on U.S. trade in goods and services in October was little changed from its September level but was slightly smaller than its average for the third quarter. The value of exports was up considerably in October from its third-quarter average; the largest gains were in machinery, agricultural products, and industrial supplies. The value of imports also rose in October. The rise in imports was spread across all major trade categories, with the largest increases being in capital goods and oil. The limited information available for the fourth quarter suggested that the Japanese economy remained mired in recession and that the pace of economic growth in most of the other major industrial countries was slowing. Activity in most of the Asian developing economies remained depressed, though there were signs that activity in some was nearing a trough and that growth in China and Taiwan had picked up somewhat. In contrast, economic conditions in most Latin American economies had worsened considerably in recent months.

Consumer price inflation remained subdued in November, with both the overall index and the index excluding food and energy items rising at the same relatively low rates as in October. For the twelve months ended in November, the increase in core consumer prices was a little higher than in the previous twelve-month period, reflecting slightly bigger advances in the prices of both commodities and services. A similar pattern was evident in producer prices of finished goods other than food and energy; core producer prices continued to rise at a low rate in November, and the increase in these prices in the twelve months ended in November was somewhat larger than in the previous twelve-month period. In contrast, prices for crude and intermediate materials continued their downward trend in both the October-November period and the twelve months ended in November. Growth in average hourly earnings of production or nonsupervisory workers had slowed over recent months to a modest rate in October and November. While the deceleration in hourly earnings was relatively widespread across industries, and most pronounced in manufacturing, wages continued to accelerate in the services industries and in finance, insurance, and real estate.

At its meeting on November 17, 1998, the Committee adopted a directive that called for implementing conditions in reserve markets that were consistent with a one-quarter percentage point decrease in the federal funds rate to an average of around 4-3/4 percent. The Committee also decided that moving to a symmetric directive would be appropriate, given that further easing likely would not be needed over the months ahead unless unexpected developments were to point toward a more substantial weakening in the growth of economic activity or to less inflation than was currently anticipated. The reserve conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over the months ahead.

Open market operations immediately after the meeting were directed toward implementing the desired slight easing in the degree of pressure on reserve positions, and through the remainder of the intermeeting period the Manager sought to maintain that easier stance. The federal funds rate remained very close to its intended lower level on average, and most other short-term market rates registered small mixed changes. Longer-term Treasury rates declined somewhat in response to a weaker outlook for foreign economic activity and the potential damping effect of lower commodity prices on inflation. Share prices in U.S. equity markets remained volatile but posted substantial increases on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar fell slightly over the intermeeting period in relation to other major currencies and also in terms of an index of the currencies of other countries that are important trading partners of the United States. Concerns about the vulnerability of U.S. markets to financial difficulties in Brazil and uncertainty generated by the impeachment proceedings were said to weigh on the dollar at times. The dollar's larger decline against the Japanese yen than against the German mark and other European currencies may have stemmed from a disparity in interest rate movements in those countries; long-term interest rates rose in Japan, partly in anticipation of heightened financing requirements associated with further fiscal stimulus, while European interest rates fell in response to cuts in official interest rates and weaker-than-expected economic data. Financial conditions affecting emerging market economies continued to improve for a time after the Committee eased monetary policy at its November 17 meeting, but that trend was subsequently reversed after Brazil's legislature decided to reject a key fiscal reform measure.

M2 and M3 had continued to expand rapidly in recent months, although incoming data indicated that growth was slowing somewhat in December. The continued strength of M2 in November reflected the reduction in its opportunity cost as a result of recent easings of monetary policy, greater growth of liquid deposits in association with heavy mortgage refinancing activity, and brisk demand for U.S. currency both at home and abroad. M3 growth was bolstered by further large flows into institution-only money market funds and additional RP financing in association with hefty acquisitions of securities by banks. For the year through November, both aggregates rose at rates well above the Committee's annual ranges. Total domestic nonfinancial debt had expanded in recent months at a pace somewhat above the middle of its range. Continued paydowns of debt by the federal government were more than offset by appreciable growth of private demands for credit to finance strong spending on durable goods, housing, and business investment, as well as merger and acquisition activity.

The staff forecast prepared for this meeting pointed to considerable slowing in the expansion of economic activity in the year ahead to a pace somewhat below the estimated growth of the economy's potential. However, the expansion was expected to pick up later to a rate more in line with that potential. Subdued expansion of foreign economic activity and the lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place continuing, albeit diminishing, restraint on the demand for U.S. exports for some period ahead and to lead to further substitution of imports for domestic products. In addition, growth in private final demand would be restrained to some extent by the tighter terms and conditions that were now being imposed by many types of lenders, by the anticipated waning of positive wealth effects stemming from earlier large increases in equity prices, and by the buildup of stocks of consumer durables, housing units, and business capital goods. Pressures on labor resources were likely to ease slightly as the expansion of economic activity moderated, but inflation was projected to rise noticeably over the year ahead, largely in association with a partial reversal of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic conditions, members commented that moderate growth at a pace close to the economy's potential remained a reasonable expectation for the year ahead. The members recognized, however, that such a projection was subject to an unusually wide range of uncertainty in both directions. On the upside, they emphasized the marked resilience and persisting strength of private domestic demand, which had kept the economy expanding at a faster pace than most had anticipated. In addition, members commented that domestic financial conditions, including the rebound in stock market prices, currently were supportive of further expansion in aggregate demand,

and in that regard several noted the continued rapid growth of the broad monetary aggregates. Still, domestic financial markets remained unusually sensitive and subject to relatively pronounced adjustments to unanticipated developments that could have substantial effects on confidence and economic activity. The external sector continued to represent a major source of downside risk; the economies of several industrial countries seemed to be weakening, and the outlook for several key emerging market economies remained in doubt, with a further loss of confidence and contagion from the latter a continuing threat. With regard to the outlook for inflation, members reported that labor markets were extraordinarily tight across the nation, but they saw only limited evidence of accelerating wage increases and little or no evidence of rising inflation in broad measures of prices. Several commented, however, that the risks of inflation appeared to be tilted to the upside, given the continuing strength of the domestic expansion and accommodative financial conditions.

In their review of developments in various parts of the country and major industries, members referred to widespread evidence of high levels and strong growth of overall domestic production and demand, but also to the continued retarding effects of the foreign trade sector on agriculture and manufacturing and extractive industries. Growth in consumer spending was expected to moderate over coming quarters from a very robust pace. Factors contributing to this assessment included expectations of somewhat slower growth in employment and incomes and the prospect that increases in financial wealth would moderate or even end at some point. Members also referred to the possibility that the very low saving rate would tend to limit increases in consumer spending, but they noted that high levels of consumer confidence and wealth along with low interest rates should help to sustain at least moderate growth in coming quarters.

Forecasts of business investment spending pointed to appreciable deceleration in the year ahead after very rapid increases in recent years. Among the factors cited in support of a slowing uptrend were the anticipated slower growth in overall demand and the large cumulative buildup of business capital that had resulted in comparatively subdued pressures on capacity. Forecasts of reduced growth in business expenditures tended to be supported by anecdotal reports that many business firms were planning to trim their capital outlays during the year ahead. Perhaps the slower growth in corporate earnings, which had been evident since earlier in the year, and reduced cash flows were beginning to exert some restraint on business capital spending. Some members observed, however, that there was little evidence thus far of any deceleration in business equipment expenditures and that the persistence of tight labor markets should continue to encourage relatively rapid growth in labor-saving business capital.

Housing activity had displayed a great deal of strength in recent months according to both anecdotal and statistical reports at this meeting. Comparatively warm weather had extended the building season in several areas, while rising incomes and low interest rates had continued to stimulate housing demand. Some retrenchment in housing activity from currently high levels seemed likely over coming quarters, given the recent large additions to the stock of housing units and some anticipated deceleration in the growth of jobs and incomes.

Members viewed the foreign sector as likely to exert a smaller negative effect on domestic growth in the year ahead. This view was based on the expectation of some stabilization or improvement in foreign financial markets and economies. In addition, the foreign exchange value of the dollar had been declining in recent months, and the effects of its earlier appreciation on the trade balance would be waning. However, they recognized that net exports could turn out to be substantially more negative than the modal forecast, given the persistence of very fragile financial and economic conditions in several large emerging economies, continued weakness in the Japanese economy, and questions about the prospective strength of economic activity in other industrial nations. As recent experience had demonstrated, a crisis in one or a group of important financial markets and economies could spread rapidly around the world.

The outlook for inflation remained favorable, though some members referred to a number of upside risks going forward. For now, however, there were few signs of rising price inflation despite widespread indications of very tight labor markets, including reports of further tightening in some areas. Indeed, the most recent wage and price data were encouraging. Increases in core measures of prices were limited and sizable declines in oil and commodity prices should help to moderate inflation going forward, in part by holding down inflation expectations. Looking beyond the nearer term, current forecasts suggested that moderating growth in overall economic activity would tend to limit pressures on resources and foster relatively subdued price inflation in the context of robust productivity growth and ample industrial capacity. Members who viewed the risks as tilted mainly to the upside commented that the effects of the anticipated reversal of a number of factors--including the declines in oil and commodity prices and restrained increases in health care costs--that had tended to hold down overall inflation might turn out to be more pronounced than was currently forecast. Moreover, underlying cost and price pressures might emerge more rapidly under such circumstances, especially if overall demand continued to outpace the growth of potential. Some members also referred to the potential inflationary effects over time of the continuation of quite rapid monetary growth. On balance, however, the members generally believed that prospective trends in overall economic activity and the persistence of strong competitive pressures in most markets, including the effects of foreign competition, were likely in the context of now firmly embedded expectations of low inflation to moderate any tendency for price inflation to accelerate over the year ahead.

In the Committee's discussion of policy for the intermeeting period, all the members agreed on the desirability of maintaining an unchanged policy stance. The System's policy easing actions since late September had helped to stabilize a dangerously eroding financial situation, and current financial conditions as well as underlying economic trends suggested that needed policy adjustments had been completed. For now at least, monetary policy appeared to be consistent with the Committee's objectives of fostering sustained low inflation and high employment. Accordingly, the Committee had entered a period where vigilance was called for but where the direction and timing of the next policy move were uncertain.

As already noted, Committee members saw risks on both sides of their forecasts. Persistently strong demand and increasingly supportive conditions in debt and equity markets suggested the possibility of rising inflation pressures. But greater disturbances abroad, especially if they were to be transmitted to domestic financial markets, could exert considerable restraint on the domestic economy. Fortunately, with low inflation, if not price stability, increasingly embedded in expectations, the Committee would have time to react to potential inflationary pressures. In the event of downward shocks to the expansion, prompt action to ease policy would be needed, but such shocks could not be anticipated at this point. Against this background, all the members indicated that they were in favor of retaining the symmetry in the existing directive.

Prior to its vote on policy at this meeting, the Committee discussed the wording of the operating paragraph of the directive, building on progress made toward a consensus at previous meetings. Attention focused in part on proposed new wording to describe the possibility of intermeeting actions. There were minor differences about specific wording, but no strongly held opinions, and all the members agreed that the new wording preferred by a majority of the members represented an improvement over the traditional language in that it would communicate more clearly and succinctly the substance of the Committee's policy decisions. The Committee also discussed deleting the last sentence in the operating paragraph relating to the outlook for the growth of money; another paragraph in the directive would continue to report the long-run ranges for such growth that the Federal Reserve Act requires the Committee to establish. With regard to the proposed deletion, some felt it was desirable for the central bank to retain a reference to money in the operating paragraph; more members supported the deletion on the ground that, as had been explained to the Congress, money growth had not had any special significance for some time in the formulation of monetary policy owing to often unexplained and unexpected changes in velocity. The rewording of the sentence on symmetry and the deletion of the sentence on money were not intended to imply any change in policy or the Committee's approach to policy or its decisionmaking.

At the conclusion of the Committee's discussion, all the members supported a reworded directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 4-3/4 percent and did not contain any bias with respect to the direction of possible adjustments to policy during the intermeeting period.

The Committee then voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The information reviewed at this meeting suggests that the economy has continued to expand at a brisk pace in recent months. Growth in nonfarm payroll employment was strong in November, after more moderate gains in September and October, and the civilian unemployment rate fell to 4.4 percent. Total industrial production declined somewhat in November, but manufacturing output was stable and up considerably from the third-quarter pace. Business inventory accumulation slowed appreciably in October after a sizable rise in the third quarter. The nominal deficit on U.S. trade in goods and services narrowed slightly in October from its third-quarter average. Total retail sales rose sharply in October and November, and housing starts were strong as well. Available indicators point to a considerable pickup in business capital spending after a lull in the third quarter. Trends in various measures of wages and prices have been mixed in recent months.
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> Most short-term interest rates have changed little on balance since the meeting on November 17, but longer- term rates have declined somewhat. Share prices in equity markets have remained volatile and have posted sizable gains on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has declined slightly over the period in relation to other major currencies and in terms of an index of the currencies of other countries that are important trading partners of the United States.

M2 and M3 have posted very large increases in recent months. For the year through November, both aggregates rose at rates well above the Committee's annual ranges. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat above 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 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.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 4-3/4 percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

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

Votes against this action: None.

Disclosure Policy
The members also discussed various issues relating to the timing and manner of releasing information about the Committee's policy decisions. A range of views was expressed, as at earlier meetings, on the desirability of releasing a statement routinely not only after those meetings at which there was a change in the stance of policy but also after meetings where the Committee altered its view of the direction of possible policy actions during the intermeeting period. Members who favored more announcements believed that such disclosure, by providing more information on the Committee's views of the risks in the economic outlook, generally would allow financial market prices to reflect more accurately the likely future stance of monetary policy. However, other members were concerned that such announcements often would provoke market reactions. As a consequence, the Committee would become less willing to change the symmetry in the directive, and a policy of immediate release might therefore have adverse repercussions on the Committee's decision-making. Nonetheless, the members decided to implement the previously stated policy of releasing, on an infrequent basis, an announcement immediately after certain FOMC meetings when the stance of monetary policy remained unchanged. Specifically, the Committee would do so on those occasions when it wanted to communicate to the public a major shift in its views about the balance of risks or the likely direction of future policy. Such announcements would not be made after every change in the symmetry of the directive, but

only when it seemed important for the public to be aware of an important shift in the members' views. On the basis of experience with such announcements, the Committee would evaluate later whether further changes in its approach to disclosures would be desirable.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, February 2-3, 1999.

The meeting adjourned at 12:55 p.m.

Donald L. Kohn
Secretary