FEDERAL RESERVE press release

For Use at 4:30 p.m. July 11, 1986

The Federal Reserve Board and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on May 20, 1986. This record also includes policy actions taken during the period between the meeting on May 20, 1986, and the next regularly scheduled meeting held on July 8-9, 1986.

Records for each meeting of the Committee are made available a few days after the next regularly scheduled meeting and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based solely on the information that was available to the Committee at the time of the meeting.

Attachment

RECORD OF POLICY ACTIONS OF THE
FEDERAL OPEN MARKET COMMITTEE

Meeting Held on May 20, 1986

1. Domestic policy directive

The information reviewed at this meeting indicated a mixed pattern of economic developments. On balance, growth in real GNP, estimated by the Commerce Department to have picked up in the first quarter to an annual rate of 3.7 percent, appeared to be expanding at a relatively modest pace in the current quarter. Thus far in 1986, broad measures of prices, heavily influenced by sharp reductions in petroleum prices, had shown declines in energy and food prices and moderate increases in prices of most other goods and services.

Total nonfarm payroll employment rose 200,000 further in April, after increasing about 3/4 million in the first quarter, but employment trends continued to be unbalanced across industries. Employment in finance and service industries remained strong, and hiring at construction sites picked up substantially after changing little in the first quarter. In manufacturing, however, job losses were recorded for the third consecutive month, and the length of the average factory workweek slipped from the high levels registered at the end of last year. Employment in the oil and gas industry plummeted during the first four months of the year, as firms curtailed drilling activity in response to lower oil prices. The civilian unemployment rate edged down to 7.1 percent in April, close to the level that had prevailed throughout 1985.

The index of industrial production rose an estimated 0.2 percent in April after steep declines in the preceding two months. The increase was attributable mainly to a rebound in motor vehicle assemblies, but there were also some gains in steel output and in production of equipment for business and for defense and space; these developments offset a further plunge in oil and gas well drilling. The index of capacity utilization for total industry dropped 0.7 percent further in March to 79.3 percent, its lowest level since December 1983, and apparently changed little in April.

Total retail sales rose 1/2 percent in April, primarily reflecting a substantial increase in spending for automotive products and continued gains in outlays for general merchandise. Sales of domestic automobiles, sparked by a new series of sales and financing incentives, strengthened to an annual rate of 8.0 million units from their sluggish pace of 6.9 million units in March. Sales rose even further in early May to a rate of 8.8 million units.

Total private housing starts increased about 4 percent in April from a relatively high level. During the first four months of 1986, starts averaged nearly 2 million units at an annual rate, well above levels of about 1-3/4 million units in each of the previous three years. Issuance of residential building permits also rose somewhat in April, with the increase concentrated in the single-family sector. Permits for multifamily structures fell, apparently in response to high rental vacancy rates, particularly in the South, and perhaps to heightened uncertainties about the prospects for changes in tax legislation relating to certain types of real estate investment.

Weakness in the energy sector has contributed to a slowing in business capital spending in recent months. Outlays for nonresidential structures fell sharply as spending on petroleum drilling activity plummeted. Expenditures for capital equipment dropped substantially, about reversing the rise in the previous quarter that was attributed to purchases of equipment in advance of potentially adverse tax law changes. New orders for nondefense capital goods, which had been flat in the fourth quarter, remained lackluster through March. Recent surveys of capital spending plans point to no more than modest growth in outlays for the year as a whole.

Largely reflecting declines in energy prices, the producer price index fell 0.6 percent in April, its fourth consecutive monthly decline, and over the first four months of the year the index was down about 11 percent at an annual rate. The consumer price index had fallen 0.4 percent in March for the second month in a row, and had declined at an annual rate of about 2 percent over the first three months of the year. Though movements in these indexes were dominated by the sharp drop in prices of petroleum products, declines in food prices at both the producer and consumer levels also helped to hold down inflation in the first quarter. On the other hand, prices of goods other than food and energy items generally have been rising in recent months at about the same pace that prevailed last year, while prices of services have been increasing a little faster than in 1985.

The trade-weighted value of the dollar against major foreign currencies rose somewhat in the week before this meeting but on balance it had declined about 4-3/4 percent further over the period since the Committee's meeting on April 1; the largest decline was against the Japanese yen. There was little net change over the period in the differential between U.S. and a weighted average of foreign interest rates. Throughout the period, but especially around the time of the Tokyo Summit in early May, statements of U.S. and foreign officials appeared to influence trading behavior. The U.S. merchandise trade deficit appeared to have decreased somewhat in the first quarter, as both the volume and average price of oil imports fell and nonagricultural exports picked up.

At its meeting on April 1, 1986, the Committee had adopted a directive that called for maintaining about the existing degree of pressure on reserve positions. The members expected such an approach to policy implementation to be consistent with growth of both M2 and M3 at an annual rate of about 7 percent for the period from March to June. Over the same period, M1 was expected to expand at an annual rate of about 7 to 8 percent, but the members recognized that the behavior of M1 remained subject to unusual uncertainty. The Committee agreed that somewhat lesser or somewhat greater reserve restraint might be acceptable over the intermeeting period depending on the behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The intermeeting range for the federal funds rate was retained at 6 to 10 percent.

M1 grew at an annual rate of 14-1/2 percent in April, close to its rapid pace in March, and data available thus far for early May indicated further strong expansion. M1 has expanded more rapidly than the Committee expected at the time of its April 1 meeting, and for the year-to-date has grown at a rate well above the 8 percent upper limit of the Committee's range for 1986. M2 and M3 expanded in April at annual rates of about 13-3/4 percent and 10-1/2 percent, respectively, also outpacing the growth paths previously expected for the second quarter. However, given its earlier weakness, M2 moved only into the lower part of its long-run range in April, while M3 rose to a level slightly above the midpoint of its range for 1986. Expansion of total domestic nonfinancial debt, which had slowed appreciably over the first quarter, appeared to be continuing at a relatively moderate pace.

Open market operations during the intermeeting period were directed at maintaining about the prevailing degree of pressure on reserve positions. During the three full reserve maintenance periods after the April 1 meeting, seasonal plus adjustment borrowing from the discount window averaged about $275 million. Borrowing was exceptionally light in the days immediately preceding the announcement on April 18 of a reduction in the discount rate from 7 to 6-1/2 percent, but has averaged a little more than $300 million since then.

Federal funds generally traded in the 6-3/4 to 7 percent area over most of the intermeeting period, down about 1/2 percentage point from the rate prevailing around the time of the previous meeting. Most other short-term rates also declined on balance, though by less than the federal funds and discount rates, while long-term rates moved somewhat higher. After declining early in the intermeeting period, interest rates subsequently rose against the background of an upturn in oil prices, strong money supply growth, further depreciation of the dollar, and emerging views among market participants that the scope for further easing in monetary policy was reduced.

The staff projections presented at this meeting suggested that expansion in real GNP, though relatively modest in the current quarter, would likely strengthen over the second half of 1986 and would be at a moderate pace in 1987. The rate of unemployment was expected to decline marginally over the projection horizon. The general level of prices, as measured by the GNP implicit deflator, was projected to rise relatively slowly in the near term, but to pick up later as the favorable effects of declining oil prices dissipated and upward pressures on prices from the dollar's depreciation tended to intensify.

In the Committee's discussion of the economic situation and outlook, members commented that stronger economic expansion in line with the staff forecast was a reasonable expectation for the second half of the year, but several members also stressed the risks of a different outcome. It was generally noted that there was no firm evidence to date of a pickup from the currently sluggish rate of expansion in overall economic activity and that weaknesses remained in key sectors of the economy such as energy and agriculture. However, a number of fundamental factors pointed to faster growth later, though there was considerable uncertainty about both the timing and the magnitude of the prospective strengthening. These factors included substantially reduced interest rates, higher prices in equity markets, lower oil prices, and the favorable effects of the dollar's depreciation on the international competitiveness of U.S. products. At the same time, some members observed that inflationary pressures could increase over the next several quarters, particularly if domestic demands for goods and services proved to be quite strong at a time when the lagged price effects of the dollar's depreciation were being felt. It was noted in this connection that progress toward reducing federal budget deficits was urgently needed to improve prospects for balanced economic growth and help protect against renewed inflation.

With regard to specific indications of prospective strengthening in economic activity, members referred among other developments to the apparent improvement in business confidence in many parts of the country. Housing activity was described as strong in most areas, and some members cited evidence of a pickup in sales of consumer durables related to housing. And although activity in manufacturing industries tended to remain sluggish, the service industries generally were experiencing considerable growth, including notably the financial services and tourism. While the staff forecast had indicated continuing growth of consumer spending and modest expansion in business fixed investment and inventories, one member referred to the possibility that expansion in these key sectors might gather momentum as uncertainties about the actual strength of business were resolved favorably, contributing to a greater acceleration in real economic growth. Another member commented that the buildup of liquidity was seen by many observers as a positive factor for the expansion, especially in the context of what was viewed as an accommodative monetary policy. While broad measures of liquidity had not shown particular strength in recent quarters, holdings of cash balances had been expanding rapidly and were available to support a considerable pickup in spending at some point in the future.

On the other hand, several members indicated that the possibility of the expansion remaining weak could not be ruled out. In this regard, a number of members indicated that they viewed business fixed investment as a major uncertainty in the overall economic outlook, noting that current indicators of future investment remained weak and that there was considerable reluctance to undertake some investment activities pending the passage of tax reform legislation. Moreover, the apparent overbuilding of commercial and other facilities in some parts of the country and weak investment demand in depressed sectors of the economy would tend to inhibit investment spending over the quarters ahead. Members also referred to shortfalls in revenues of state and local governments in depressed areas of the country as a negative factor. Finally, one member referred to the possibility of an inventory correction should the currently positive business mood begin to deteriorate.

A number of members expressed the view that the performance of the economy during the second half of the year would hinge to a considerable extent on foreign developments. Some felt that the main downside risks in the nearer-term business outlook were on the foreign trade side. To an important degree, rising demands for U.S. exports would depend on faster growth in key foreign industrial nations, and it was observed that such growth had been disappointing and a pickup might not occur in the absence of more stimulative economic policies in at least some of those countries. And while a depreciated dollar could be expected to have a favorable impact on U.S. foreign trade over time, that impact might well be delayed and muted in an environment of slow growth abroad and of highly competitive markets for internationally traded goods. Further growth in protectionism in the United States might likewise have a strongly inhibiting effect on U.S. export markets as foreign nations retaliated.

A number of members raised questions about the outlook for inflation. It was pointed out that the recently favorable behavior of overall prices was the result of price declines in the energy and food sectors. Those declines would soon be in the past, and upward pressures on overall prices would re-emerge, stimulated in part by the lagged inflationary effects of the dollar's depreciation. Indeed, prices of nonfuel imports were already indicated to have turned up. Even if oil prices were to stabilize near current levels, their favorable impact on overall prices would tend to wane over the quarters ahead, and the possibility of a reversal in oil prices could not be dismissed. Agricultural prices also could not be expected to continue trending downward, and indeed some firming had occurred recently. On the more favorable side, members referred to the intense competition in many markets and to restrained wage settlements in a number of industries. Basic cost pressures appeared to be well contained so far in manufacturing industries although price and wage pressures in the service industries remained disturbing. In one view any intensification of inflationary pressures might well be delayed until well into 1987.

At its meeting in February the Committee had agreed on policy objectives for monetary growth for the period from the fourth quarter of 1985 to the fourth quarter of 1986 that included ranges of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3. The associated range for total domestic nonfinancial debt was set at 8 to 11 percent. In keeping with the Committee's usual procedures under the Humphrey-Hawkins Act, these ranges would be reviewed at the July meeting when provisional ranges would also be established for 1987.

The Committee's policy discussion focused to a considerable extent on the members' evaluation of the recent behavior of the monetary aggregates, particularly M1. With varying degrees of emphasis, members questioned the reliability of M1 developments as a guide for the conduct of monetary policy under prevailing circumstances. It was noted in this connection that the rapid growth in M1 and the associated weakness in its velocity appeared to reflect to a considerable but nonetheless uncertain extent the earlier declines that had occurred in market interest rates in the context of subsiding inflationary expectations and softness in final demands. From this viewpoint, the relatively rapid growth in the demand for money balances needed to be accommodated in order to assure a satisfactory performance of the economy. On the other hand, rapid monetary growth also might imply an excessive buildup in liquidity, with inflationary implications for the future. In that context, several members emphasized the need to gauge the performance of M1 in light of whether behavior of other, broader, monetary aggregates provided confirming evidence of a rapid growth in liquid assets.

Members noted that expansion of the broader aggregates, despite the more rapid growth in recent weeks, was well within the Committee's ranges for 1986, and indeed near the lower end of the range in the case of M2. The more moderate growth of the broader aggregates this year, along with relatively moderate growth of L, an even more encompassing measure of the public's liquid asset holdings, raised questions as to whether the growth of M1 really represented a potentially excessive buildup in liquidity or was more of a shift in the composition of liquid holdings in response to relative movements in interest rates. However, continuing growth in M2 and M3 at the relatively rapid rates experienced recently could be a matter of increasing concern. One member expressed a somewhat differing assessment of the behavior of the broader aggregates this year, in that the contingent liabilities of banks, most of which back instruments that are not included in M2 and M3, also seemed to have grown rapidly. Moreover, growth of M2 and M3 appeared to have been held back by investor portfolio shifts into bonds and equities, including mutual funds, and the unwinding of such shifts could result in faster growth later. In this view, therefore, less comfort could be taken from the relatively restrained growth of the broader aggregates for the year to date.

According to an analysis prepared for this meeting, the maintenance of the current degree of pressure on reserve positions could be expected to be associated with slower monetary growth over the balance of the quarter. Even so, because of the substantial expansion in April and early May, growth for the quarter as a whole would be considerably faster than was expected at the time of the previous meeting, notably in the case of M1. According to this analysis, the unusual surge in demand deposits was likely to subside over the course of coming weeks, while some moderation could also be expected in the growth of NOW accounts as both depositors and depository institutions completed their adjustments to the lower market interest rates that had emerged. Members indicated broad agreement with this analysis, but they questioned the timing and extent of the slower growth. In light of the uncertainties that were involved, some proposed omitting numerical references in the directive to the Committee's expectations for monetary growth in the second quarter. However, despite the greater than usual uncertainties, a majority of the members preferred to retain the customary procedure of specifying numerical growth expectations in the directive.

In the Committee's discussion of policy implementation for the period immediately ahead, most of the members indicated that they were in favor of continuing to direct open market operations at least initially toward maintaining the existing degree of reserve availability. In support of this view, members commented that the rapid growth of the monetary aggregates and the favorable conditions for a pickup in business activity had to be weighed against the currently sluggish growth in overall business activity and the consequent uncertainties surrounding the economic outlook. One member felt, however, that the rapid growth in M1 and the potential for increased inflationary pressures later in the year and in 1987 argued for some firming.

With regard to possible adjustments during the intermeeting period, a majority of the members felt that policy implementation should be alert to the potential need for some firming of reserve conditions, especially if business indicators gave a clear signal of a pickup in the rate of economic expansion and monetary growth did not slow in line with expectations. Generally, these members did not want to rule out the possibility of some easing in the weeks immediately ahead, but they foresaw the potential desirability of such a course only in the context of appreciably more sluggish economic performance than was now expected. In this connection, one member emphasized that continuing declines in the velocity of money in combination with a sluggish economic performance might warrant some easing of reserve conditions. Other members believed that there should be no presumptions about the likely direction of any intermeeting adjustments, given the prevailing uncertainties about the performance of the economy, possible developments in domestic and international financial markets, and the behavior of the monetary aggregates. Some members also expressed the view that the Committee should be tolerant of a shortfall of M1 growth below current expectations in light of the rapid expansion of M1 recently and for the year-to-date. It was noted that account needed to be taken of the behavior of the dollar on foreign exchange markets in any intermeeting adjustments.

At the conclusion of the Committee's discussion, all but one member indicated their acceptance of a directive that called for no change in the existing degree of pressure on reserve positions. The members expected such an action to be associated with a deceleration in monetary growth over the balance of the second quarter. Because such growth had been rapid thus far in the quarter, the members anticipated faster growth of the monetary aggregates, especially M1, than was expected at the time of the April 1 meeting. The members recognized that the behavior of M1 remained subject to unusual uncertainty, but they agreed that its growth might be in the area of 12 to 14 percent for the period from March to June, assuming some decline over the balance of the quarter. For the same period, M2 and M3 were now expected to expand at annual rates of around 8 to 10 percent. The members agreed that if the anticipated slowing in monetary growth did not occur, somewhat greater reserve pressure would be acceptable in the context of a pickup in the expansion of economic activity, with account being taken of conditions in domestic and international financial markets and the behavior of the dollar on foreign exchange markets. On the other hand, somewhat lesser reserve restraint might be acceptable in the event of pronounced sluggishness in the performance of the economy in association with a marked slowing in monetary growth.

The Committee agreed that the current intermeeting range for the federal funds rate should be reduced by 1 percentage point to 5 to 9 percent. The reduction was intended as a purely technical adjustment in the context of an unchanged degree of reserve availability and its purpose was to provide a more symmetrical range around the lower federal funds rate that had prevailed for some time. The members regard the federal funds range as a mechanism for initiating Committee consultation when its boundaries are persistently exceeded.

At the conclusion of the meeting the following domestic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting indicates a mixed pattern of developments but suggests on balance that economic activity is expanding at a relatively modest pace in the current quarter. Total nonfarm payroll employment increased moderately further in April following a considerable rise in the first quarter, but employment in manufacturing fell for the third consecutive month. The civilian unemployment rate edged down to 7.1 percent. Industrial production and total retail sales turned up in April following earlier declines, while housing starts rose somewhat further from a relatively high level. Weakness in the energy sector has contributed to a slowing of business capital spending. The merchandise trade deficit appears to have decreased somewhat in the first quarter, as the

volume and average price of oil imports fell. Largely reflecting declines in energy prices, consumer prices have declined somewhat since late 1985 and producer prices have fallen substantially.

In April M1 continued to grow at a rapid pace, leaving this aggregate above the upper end of its range for the year. Growth of the broader aggregates, especially of M2, strengthened considerably in April, bringing M2 into the lower part of its long-run range and M3 slightly above the midpoint of its range for 1986. Most short-term interest rates have declined on balance since the April 1 meeting of the Committee, while long-term rates are somewhat higher. On April 18, the Federal Reserve Board approved a reduction in the discount rate from 7 to 6-1/2 percent. The trade-weighted value of the dollar against major foreign currencies has risen somewhat recently but on balance the dollar has declined further since the April meeting, particularly against the Japanese yen.

The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at its February meeting to establish the following ranges for monetary growth, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate was subject to substantial uncertainties in relationship to economic activity and prices, depending among other things on its responsiveness to changes in interest rates. It agreed that an appropriate target range under existing circumstances would be 3 to 8 percent, but it intends to evaluate movements in M1 in the light of its consistency with the other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures. It adopted a range of 6 to 9 percent for M2 and 6 to 9 percent for M3. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for the year 1986.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with a deceleration in money growth over the balance of the quarter. However, in view of the rapid money growth thus far in the quarter and the apparent weakness in velocity, the Committee anticipates faster growth for the monetary aggregates, particularly M1, than expected at the last meeting. M2 and M3 are expected to expand over the period from March to June at annual rates of about 8 to 10 percent. While the behavior of M1 continues to be subject to unusual uncertainty, growth at an annual rate of about 12 to 14 percent over the period is now anticipated. If the anticipated slowing in monetary growth does not develop, somewhat greater reserve restraint would be acceptable in the context of a pickup in growth of the economy, taking account of conditions in domestic and international financial markets and the behavior of the dollar in foreign exchange markets. Somewhat lesser reserve restraint might be acceptable in the context of a marked slowing in money growth and pronounced sluggishness in economic performance. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 5 to 9 percent.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Mrs. Horn, Messrs. Johnson, Melzer, Morris, Rice, and Ms. Seger. Vote against this action: Mr. Wallich. Absent and not voting: None.

Mr. Wallich dissented because he preferred to direct open market operations toward somewhat greater restraint. He was concerned about the implications of rapid monetary expansion for inflation and wanted to take action promptly to help assure slower monetary growth.

2. Authorization for Domestic Open Market Operations

On June 18, 1986, the Committee approved a temporary increase of $3 billion, to $9 billion, in the limit between Committee meetings on changes in System Account holdings of U.S. government and federal agency securities specified in paragraph 1(a) of the authorization for domestic open market operations. The increase was effective immediately for the intermeeting period ending with the close of business on July 9, 1986.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Mrs. Horn, Messrs. Johnson, Morris, Rice, and Boykin. Votes against this action: None. Absent and not voting: Mr. Melzer, Ms. Seger and Mr. Wallich. (Mr. Boykin voted as alternate for Mr. Melzer.)

This action was taken on the recommendation of the Manager for Domestic Operations. The Manager had advised that through June 17, outright purchases of securities thus far in the intermeeting interval had reduced the leeway under the usual $6 billion limit to about $2-1/4 billion. It was anticipated that substantial additional purchases of securities in excess of that leeway would be necessary over the remainder of the intermeeting period. Currency in circulation was expanding rapidly, as expected, while required reserves were growing considerably faster than had been anticipated earlier.