FEDERAL RESERVE press release

For Use at 4:30 p.m. February 13, 1987

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 December 15-16, 1986.

Such 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 December 15-16, 1986

Domestic policy directive

The information reviewed at this meeting suggested that economic activity was continuing to expand at a moderate pace in the current quarter. Payroll employment increased considerably in October and November; hiring in manufacturing rose somewhat in both months after declining on balance since the beginning of the year. Apart from sales of motor vehicles, which dropped off with the end of financing incentive programs, consumer spending has posted sizable gains in recent months. Business investment spending, however, has remained sluggish, while housing starts have weakened. At the same time, the trade balance has shown only limited indications of improvement. Increases in labor costs still were moderate, but price increases have been somewhat higher than earlier in the year because of developments in food and energy markets.

Total nonfarm payroll employment rose about 1/4 million in both October and November. Much of the gain was in the private service-producing sector, but factory employment also rose moderately, and the workweek lengthened. Aggregate hours for production and nonsupervisory workers in November were a full percentage point above the third-quarter average. The civilian unemployment rate stayed at 7 percent in November for the third consecutive month.

Gains in employment and hours worked were associated with a sizable pickup in industrial production in November. The industrial production index rose 0.6 percent last month, after essentially no change over the previous three months. Increases in output were evident in most major marketing groups, with only energy materials showing a marked decline, although auto assemblies were about unchanged from October. Capacity utilization in manufacturing, mining, and utilities rose 0.3 percentage point in November to 79.3 percent. Nonetheless, utilization has changed little on balance since March and is 2-1/2 points below its most recent peak in the summer of 1984.

Sales of domestic cars fell sharply after the expiration of cut-rate financing incentive programs in early October. These sales averaged less than 7 million units at an annual rate over the October-November period, compared with the strong 9-1/2 million unit pace for the third quarter as a whole. Excluding autos, gasoline, and nonconsumer items, retail sales in November rose 0.9 percent paced by continued strength in purchases of furniture and appliances and in other nonauto durables. In addition, data for earlier months were revised upward slightly.

Business investment appears to have remained sluggish. Shipments of nondefense capital goods increased in October, and construction spending has firmed in recent months but prospects for such spending have continued to be affected adversely by high vacancy rates and reactions to tax reform. In contrast, sales of heavy-weight trucks fell markedly in October, and business purchases of cars and light trucks also probably declined sharply after the sales incentive programs ended. At the same time, new orders for nondefense capital goods fell 5 percent. Initial surveys of capital spending plans for 1987 suggested that overall nominal spending on plant and equipment is likely to change little from the 1986 level.

Housing starts continued to decline in November. During the month total private housing starts, at 1.6 million units, were a bit below the reduced pace of September and October. Single-family starts were virtually unchanged from their rate during the preceding two months, but were below their level earlier in the year; new home sales also have remained below their previous pace in recent months. Multifamily starts declined further in November in response to high vacancy rates and adverse changes in tax laws.

Price increases, although still moderate, have been somewhat higher than earlier in the year partly because of developments in food and energy markets. The consumer price index rose 0.2 percent in October and the producer price index was up 0.2 percent in November. In the food sector, some upward price pressure continued to be evident, although increases in food prices slowed from the rapid pace during the summer. In addition, energy prices turned down a bit at both the retail and refinery levels, despite the firming of crude oil prices in spot markets since mid-summer. Excluding food and energy, the CPI rose 0.4 percent in October, somewhat faster than earlier in the year as new car prices increased sharply. Wage inflation has picked up a bit recently, but has continued at a moderate pace.

The trade-weighted value of the dollar against other G-10 currencies has declined somewhat on balance since the November 5 meeting of the

Committee. Exchange rates have been affected by news about the pace of economic activity, developments in the U.S. trade balance, and prospects for monetary actions in the United States and in key industrial nations abroad. Short-term interest rates rose moderately abroad, about in line with movements in U.S. rates, while differentials in long-term interest rates moved slightly against dollar assets. Over the period, the dollar declined about 2 percent against the mark and was essentially unchanged against the yen, but the dollar's depreciation had been somewhat larger in early December. As of mid-December, the value of the dollar in relation to other major currencies was little changed on balance from the level prevailing in August. Economic activity in major foreign industrial countries was mixed in the third quarter. The U.S. merchandise trade deficit was estimated to be about the same in the third quarter as in the previous three quarters. Exports were flat in the quarter, while the value of oil imports was close to that in the second quarter as price declines about offset volume increases. Very preliminary data indicated that the deficit in October was the smallest in recent months as exports of agricultural products rose somewhat and imports declined moderately.

At its meeting on November 5, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions. This action was expected to be consistent with growth in both M2 and M3 at annual rates of 7 to 9 percent from September to December. Growth in M1 over the same period was expected to moderate from its exceptional pace during the previous several months. The Committee agreed that the growth in M1 would continue to be evaluated in light of the behavior of the broader monetary aggregates and other factors. The members also decided that slightly greater or slightly lesser reserve restraint might be acceptable depending on the behavior of the monetary aggregates, taking into account 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 federal funds was maintained at 4 to 8 percent.

M2 growth slowed substantially in November to a 6-1/2 percent annual rate, and M3 growth moderated further to a 5-1/2 percent annual rate; through November both M2 and M3 were just inside the upper bounds of their 6 to 9 percent growth ranges established by the Committee for 1986. M1 accelerated again in November, reaching a rate of 21 percent, as growth in demand deposits surged. M1 growth has remained far in excess of GNP growth so far this year and its velocity is expected to fall at an historically high rate.

Growth of total reserves picked up sharply over the intermeeting period largely because of a surge in required reserves against transactions deposits. In addition, excess reserves increased from almost $750 million in the previous three months to around $1 billion on average in November, reflecting mainly the usual patterns around holidays and social security payment dates. Adjustment plus seasonal borrowing in the two complete maintenance periods since the November FOMC meeting averaged about $300 million, down somewhat from the average over the previous intermeeting period. Even so, the funds rate firmed from around 5-7/8 percent at the time of the last meeting to well above 6 percent in early December. More recently, the federal funds rate has averaged close to 6 percent.

With the federal funds rate firmer through much of the intermeeting period, other short-term market rates rose 15 to 50 basis points. However, bond yields generally were about unchanged to down 25 basis points. Rates on commitments for fixed-rate home mortgages dropped about one-half percentage point, moving toward a more normal alignment with Treasury bond yields. Although stock prices fell initially on the announcement of insider trading violations related to takeover activity, on balance they showed little change over the period.

The staff projections presented at this meeting suggested that real GNP would continue to grow at a moderate rate through the end of 1987. Prospects for an improvement in real net exports of goods and services continued to be a key element shaping the 1987 forecast; export growth was expected to accelerate next year and import growth to moderate as world trade flows adjusted to increased U.S. competitiveness. Gross domestic purchases were projected to be relatively sluggish through the end of 1987, reflecting mainly a shift toward fiscal restraint, the likely weakness in multifamily housing and nonresidential construction, and the damping influence of higher import prices on the growth of real income and consumption. Inflation was expected to pick up a bit in early 1987 as a consequence of the dollar's depreciation and higher energy prices.

In the Committee's discussion of current and prospective economic developments, members generally agreed that continuing expansion at a moderate pace remained a reasonable expectation for the year ahead, but a number of members emphasized the risks of a shortfall from current projections, especially in the early part of 1987. In particular, members mentioned the risks that the expected improvement in the nation's foreign trade might be relatively disappointing next year and that overall business spending might remain sluggish. A few members also referred to the possibility of slower growth in consumer spending. On balance, however, while no important sector of the domestic economy seemed likely to be a source of substantial strength in 1987, the members read current economic indicators and other business information as pointing to a fifth year of moderate expansion. Such expansion might be accompanied by some rise in the rate of inflation, primarily reflecting the effects of the dollar's depreciation and energy-sector developments.

The members again gave considerable attention to the outlook for foreign trade. An improvement in trade generally was viewed as an essential factor in sustaining a moderate rate of business expansion in the context of perhaps diminishing growth in overall domestic demands. Unfortunately, there was no convincing evidence thus far of a turnaround in the trade balance and a number of members commented that the expected improvement could be relatively limited next year. On the favorable side, the depreciation of the dollar evidently had enhanced the competitive position of U.S. firms, and individual reports of expanding export opportunities appeared to be multiplying as well as indications of an improved ability of many U.S. firms to compete domestically with imports. As they had at earlier meetings, the members referred to a number of factors that were inhibiting an overall improvement in net exports, including limited expansion in many industrial nations abroad and strong competition from a number of countries whose currencies had not appreciated against the dollar. One member also stressed that persisting debt problems in several developing countries constituted an element of vulnerability for international financial markets and international trade and also for the U.S. economy.

With regard to the domestic economy, a number of members commented that consumer expenditures on durables, especially automobiles, and some business spending appeared to have been accelerated into 1986 in reaction to provisions of the tax reform legislation. Compensating adjustments in such spending later could have a restraining effect on economic growth, notably during the first part of 1987. Nonetheless, a few members referred to the possibility that consumer spending might be well maintained during 1987 as a whole. The latter acknowledged the inhibiting effects of the growth in consumer debt, but they stressed the favorable implications of cumulative increases in the total assets and net worth of consumers and the positive impact of reductions in personal income tax rates. The outlook for business spending continued to be uncertain and in some respects unpromising, especially with regard to multifamily housing and nonresidential construction; both areas would be adversely affected by high vacancy rates and negative reactions to the tax reform legislation. There were further reports of plant closings, notably in the Midwest. However, one member observed that business spending for plant and equipment might well hold up in response to continuing growth in overall economic activity. As usual, the prospects for inventory accumulation were uncertain and would be affected by the outlook for prices.

With regard to the outlook for prices and wages, members generally agreed that increases might be somewhat larger in 1987, reflecting the impact of rising import prices and indications of a turnaround in oil prices. However, the prospect of only moderate economic growth and continued margins of slack in labor and product markets suggested that strong wage pressures were not likely over the year ahead. One member observed that agricultural conditions worldwide suggested an absence of pressure on food prices. Moreover, generally limited growth in key industrial nations together with an ample availability of productive resources abroad implied continuing strong competitive pressures and restrained advances in prices of U.S. imports. Even so, a somewhat higher rate of inflation appeared to be in prospect for next year.

At its meeting in July, the Committee had agreed on tentative ranges of 5-1/2 to 8-1/2 percent for growth in both M2 and M3 during the period from the fourth quarter of 1986 to the fourth quarter of 1987. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for 1987. In the case of M1 the Committee had indicated on a more tentative basis than usual that it might retain the 1986 range of 3 to 8 percent for 1987. Such a range implied a marked reduction from the M1 growth experienced in 1986 and provisionally assumed that the relationship of M1 to income, interest rates, and other economic variables next year would be broadly consistent with earlier historical experience.

At this meeting the Committee held a preliminary discussion of the factors bearing on appropriate ranges for the various monetary aggregates in 1987. Most of the attention was devoted to the issue of whether a range should be established for M1, given the uncertainty surrounding behavior of that aggregate and its velocity in recent years. While most members currently did not favor establishing a formal target range for M1 growth in 1987, many of them believed that this aggregate should continue to be monitored or evaluated in light of information about the economy, prices, and the broad monetary aggregates and other financial variables. The Committee will complete its review of the role of M1 and the ranges for the broad aggregates for 1987 at its February meeting.

In the Committee's discussion of policy implementation for the period immediately ahead, all of the members indicated that they were in favor of directing open market operations, at least initially, toward maintaining unchanged conditions of reserve availability. For now, monetary policy was deemed to be exerting an appropriate degree of pressure on reserve positions in light of the growth of the broader monetary aggregates within -- though at the upper ends of -- their longer-run ranges, and the generally favorable prospects for sustained, albeit moderate, economic growth.

The members recognized that the outlook for the monetary aggregates remained uncertain, notably in the case of M1. According to an analysis presented at this meeting, a moderate trend in the growth of M2 and M3 might be anticipated, given the outlook for fairly limited growth in economic activity and an abatement of the effects of earlier interest rate declines. For the months ahead, growth in the broader aggregates might be well within the Committee's tentative ranges for 1987 on the assumption that there would be no significant changes in market interest rates. The outlook for M1 growth remained highly uncertain, although underlying forces seemed consistent with a considerable slowing over time from the extraordinary expansion experienced during 1986. Some concern was expressed that the failure of such a slowing to occur and the associated large provision of reserves could eventually have inflationary consequences. Even with some moderation over coming months, M1 might continue to expand at rates markedly in excess of the growth in nominal GNP. In view of the uncertainties that were involved and in keeping with the Committee's practice since mid-1986, the members did not want to indicate specific expectations with regard to M1 growth in the operational paragraph of the Committee's directive. Nonetheless, it was understood that growth of this aggregate would continue to be evaluated in light of the behavior of the broader monetary aggregates and other economic and financial developments.

In their discussion of possible intermeeting adjustments in the degree of reserve pressure, the members thought it unlikely that developments would warrant more than a minor, if any, change in reserve conditions during the weeks ahead. All of the members understood that some small adjustment in either direction might be appropriate under certain circumstances. However, in the context of what they perceived as greater downside risks in the outlook for economic activity, several believed that policy implementation should remain especially alert to developments that might call for somewhat easier reserve conditions. It was noted in this connection that the relative stability of the dollar in foreign exchange markets over the past few months provided greater flexibility for potential easing actions.

At the conclusion of the Committee's discussion, all of the members indicated that they favored a directive that called for no change in the degree of pressure on reserve positions. The members expected this approach to policy implementation to be consistent with growth of both M2 and M3 at an annual rate of about 7 percent over the 4-month period from November to March. Because the behavior of M1 remained subject to unusual uncertainty, the members decided they would continue to evaluate this aggregate in the light of the performance of the broader monetary aggregates and other factors. The members indicated that slightly greater reserve restraint or somewhat lesser reserve restraint would be acceptable over the intermeeting period depending on the behavior of the monetary aggregates, taking into account the strength of the business expansion, the performance of the dollar in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The members agreed that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 4 to 8 percent.

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 suggests that economic activity continues to grow at a moderate pace in the current quarter. Total nonfarm payroll employment grew appreciably further in October and November, and employment in manufacturing also rose after declining on balance in previous months. The civilian unemployment rate remained at 7.0 percent in November for the third consecutive month. Industrial production picked up considerably in November. Total retail sales rose moderately last month after changing

little on balance over September and October. Housing starts have weakened and business capital spending generally appears to have remained sluggish. Preliminary data for the U.S. merchandise trade deficit in October suggest a moderate narrowing. Broad measures of prices have firmed somewhat in recent months due to developments in food and energy markets. Labor cost increases this year have remained moderate compared with other recent years.

Growth of M2 slowed substantially in November, while growth of M3 remained moderate. Expansion of these two aggregates for the year through November has been just below the upper end of their respective ranges established by the Committee for 1986. In November growth of M1 accelerated to a very rapid rate. Expansion in total domestic nonfinancial debt remains appreciably above the Committee's monitoring range for 1986. Short-term interest rates have risen somewhat since the November 5 meeting of the Committee, while long-term rates have declined on balance. In foreign exchange markets the trade-weighted value of the dollar against other G-10 currencies has declined moderately on balance since the November meeting.

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 the July meeting to reaffirm the ranges established in February for growth of 6 to 9 percent for both M2 and M3, 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 is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth of M1 over the remainder of the year would depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year, the Committee recognized that the increase in total domestic nonfinancial debt in 1986 may exceed its monitoring range of 8 to 11 percent, but felt an increase in that range would provide an inappropriate benchmark for evaluating longer-term trends in that aggregate.

For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5-1/2 to 8-1/2 percent for M2 and M3. While a range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognized that the exceptional uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range at the beginning of 1987. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1987.

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 growth in M2 and M3 over the period from November to March at an annual rate of about 7 percent. Growth in M1 will continue to be appraised in the light of the behavior of M2 and M3 and the other factors cited below. Slightly greater reserve restraint or somewhat lesser reserve restraint would be acceptable depending on the behavior of the aggregates, taking into account the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. 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 4 to 8 percent.

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