FEDERAL RESERVE press release

For Use at 4:30 p.m. July 7, 1989

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 16, 1989.

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

75th ANNIVERSARY
FEDERAL RESERVE SYSTEM

RECORD OF POLICY ACTIONS OF THE FEDERAL OPEN MARKET COMMITTEE

Meeting Held on May 16, 1989

1. Domestic policy directive.

Information reviewed at this meeting suggested that the rate of economic expansion had slowed in recent months. Job gains had diminished noticeably in March and April, and industrial production was growing more slowly than in 1988. On the demand side, growth in consumer spending appeared to have slackened, and housing activity had weakened considerably. Broad measures of prices had risen somewhat more rapidly in 1989, with a significant contribution from sharp increases in energy prices. Year-over-year increases in labor costs appeared to be continuing on an upward trend but at a more gradual rate.

Gains in total nonfarm payroll employment moderated substantially in March and April from the rate recorded over the previous six months. Much of the March-April increase occurred in the services industry, where employment continued to expand at about the 1988 pace. In April, job growth slackened at wholesale and retail trade establishments, and factory employment remained a bit lower than its January level. Although new claims for unemployment insurance continued low, the civilian unemployment rate rose from 5.0 percent in March to 5.3 percent in April.

Industrial production increased in April after declining on balance over the preceding two months. The April pickup reflected a sizable rise in motor vehicle assemblies after a weak first quarter as well as a retracing of the March decline in output of other consumer goods. Production of business equipment continued to rise in April at about the strong first-quarter pace. Total industrial capacity utilization rose in April but remained below its January level. Operating rates in manufacturing edged up despite a further decline in capacity utilization in primary processing industries.

Growth in consumer spending had slowed considerably this year from the pace in 1988. A reduction in growth of spending for services along with smaller outlays for durable goods, notably motor vehicles, more than offset a pickup in expenditures for nondurable goods. In April, enhanced manufacturer incentives spurred spending on motor vehicles and boosted retail sales after a flat March, but outlays on other durable goods remained weak. After a sizable rise in the second half of 1988, housing starts weakened sharply this year. In April, a substantial drop in starts of multifamily units brought overall housing starts to their lowest level since December 1982.

By contrast, recent indicators of business capital spending showed a rebound in early 1989 after a decline in the fourth quarter. Shipments of nondefense capital goods excluding aircraft picked up sharply in the first quarter; among the major components, computers posted a sizable increase after a sharp fourth-quarter decline, and only business purchases of motor vehicles evidenced weakness. Nonresidential construction activity rebounded sharply in March from a February decline, and petroleum drilling turned up, apparently in response to increases in oil prices. In the first quarter, inventory investment in the manufacturing sector continued at about the average 1988 pace; a substantial part of this accumulation was in stocks of work-in-process in the aircraft industry where new orders and production remained on a distinct uptrend. The overall inventory-to-shipments ratio had changed little from the year-end level. At the retail level, inventory-sales ratios edged up as a result not only of further accumulations in the automotive area but also of some rise in apparel and general merchandise stocks.

After rising sharply in the first two months of the year, producer prices of finished goods advanced at a substantially less rapid pace in March and April. The April increase reflected another large jump in energy prices; prices of consumer foods turned down, partially reversing their sizable first-quarter increase, and prices of other finished goods were little changed. At the intermediate and the crude materials levels, the April price increases were attributable entirely to the surge in energy prices. Both food and energy prices contributed to the rise in consumer prices in March. Nevertheless, excluding these components, consumer prices advanced at a slightly faster rate in the first quarter of 1989 than in the fourth quarter of 1988. The year-over-year increase in this measure of consumer prices had edged up only marginally since the beginning of the year, a pattern also evident in broad measures of labor compensation.

The nominal U.S. merchandise trade deficit widened somewhat in February, but the average deficit for January and February together was smaller than that for the fourth quarter. Exports for the January-February period were well above their fourth-quarter level; much of the increase occurred in agricultural products. Imports advanced considerably less, as declines in automotive products, consumer goods, and foods nearly offset increases in oil, industrial supplies, and capital goods. Available indicators suggested that the pace of economic growth and inflation had increased on balance in the major foreign industrial countries in early 1989.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose further on balance over the intermeeting period. The dollar declined early in the period as market participants perceived central bank authorities as actively seeking a lower dollar. Despite some continued narrowing of short-term interest rate differentials between dollar-denominated assets and both mark and yen assets, the dollar subsequently rebounded; market concerns about political uncertainties in Germany and Japan apparently were a factor in the rise.

At its meeting on March 28, the Committee adopted a directive that called for no immediate change in the degree of pressure on reserve positions but that provided for giving particular weight to potential developments that might require some firming during the intermeeting period. An unchanged availability of reserves over the period was expected to be consistent with the growth of M2 and M3 over the period from March through June at annual rates of about 3 percent and 5 percent respectively. It was agreed that somewhat greater reserve restraint would, or slightly lesser reserve restraint might, be acceptable depending on indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets.

Reserve conditions remained essentially stable over the intermeeting interval following the March meeting, except that stronger-than-anticipated federal tax revenues and related reserve flows associated with the April tax date contributed for a time to slightly firmer reserve markets. In the reserve maintenance periods completed since the March meeting, adjustment plus seasonal borrowing averaged $565 million while federal funds generally traded around 9-7/8 percent or a little below.

With incoming information suggesting a more moderate pace of economic expansion, other market interest rates declined over the intermeeting period. Rates on short- and intermediate-term U.S. Treasury issues dropped almost one percentage point, and those on private money market instruments fell somewhat less. Yields generally were down 25 to 50 basis points in long-term debt markets, and major indexes of stock prices rose substantially.

M2 and M3 grew more sluggishly in April than had been anticipated, as substantial deposit outflows began after mid-month and continued into early May. Declines in transaction and other liquid balances were associated primarily with outsized personal tax payments and a shortfall in tax refunds. Growth of the broader monetary aggregates also continued to be restrained by the effects of the earlier rise in market interest rates, which had substantially increased the opportunity costs of holding deposits. Through April, expansion of M2 had been at a rate well below the Committee's range for the year, while growth of M3 had been in the lower portion of its range. Reflecting the persisting weakness in transactions balances in 1989, M1 was below its average level in the fourth quarter of 1988. Growth in total domestic nonfinancial debt slowed somewhat in April, damped by strong tax revenues that reduced the Treasury's financing needs and by a virtual halt in refundings of state and local obligations owing to the earlier climb in interest rates.

The staff projection prepared for this meeting suggested that the expansion of the nonfarm economy over the remainder of 1989 was likely to be at a pace somewhat below that officially reported for the first quarter. The projection continued to assume that the drought had ended and that normal agricultural growing conditions would prevail. The staff anticipated that, with margins of unutilized labor and other production resources remaining relatively low, most measures of prices and labor costs would increase at somewhat faster rates in 1989 than in 1988. A monetary policy to contain inflation would involve slow growth of overall demand and an easing of pressures on labor and capital resources; to the extent that strength in final demands were to persist, such a policy would imply additional pressures in financial markets. The staff projected sluggish consumer outlays for goods and services and further weakness in housing construction over the remainder of 1989. The contribution of foreign trade to growth was likely to be limited, and fiscal policy was expected to be moderately restrictive. Growth in business capital spending, particularly for equipment purchases, was expected to moderate over the rest of the year from its vigorous first-quarter pace.

In the Committee's discussion of the economic situation and outlook, members focused on accumulating indications that the expansion in business activity was slowing to a pace that they generally viewed as more sustainable and more consistent with reducing inflation pressures over time. The apparent slowing in the growth of domestic consumer demand would tend to make more domestic resources available for the production of export goods and the expansion of domestic capital. There was little evidence at this point of the kinds of imbalances that normally signal a downturn in economic activity, but some members expressed concern that a cumulative slowing of the business expansion could not be ruled out, especially since the effects of earlier policy tightening actions had not been felt fully. In this regard, the extended weakness in monetary growth, at a time of slowing economic expansion, was a worrisome development. The latest information on prices and wages was cited as encouraging, possibly indicating that the underlying rate of inflation might be leveling out, although it was still undesirably high.

In the course of the Committee's discussion, members observed that the broad indications of slower but continuing business expansion were supported by reports on regional economic developments. While conditions varied across the country, overall activity appeared to be advancing in most regions, though evidence of slower growth was apparent in some of them. Retail sales had flattened out in a number of areas. The weakness in sales was more widespread and pronounced in the case of motor vehicles, particularly after taking account of incentive programs introduced recently by auto manufacturers. Consumer spending was not likely to increase rapidly over coming quarters but should be sustained at a moderate pace by a high level of employment and further expansion in personal incomes. Housing construction was depressed in many areas, and this sector of the economy was not expected to make much, if any, net contribution to the expansion this year, at least on the assumption of unchanged financial conditions in mortgage markets. Business fixed investment presented a mixed picture by industry but, in the context of high capacity utilization rates and strong pressures to cut costs, further overall growth was viewed as a reasonable prospect following the sharp pickup in the first quarter. Conditions in agriculture were described as favorable in most parts of the nation, though some areas were still affected by drought conditions. Outside the motor vehicles sector, inventories displayed few signs of the imbalances that usually presage a downturn in production; some of the recent build-up involved work-in-process inventories in industries such as commercial aircraft that had firm order backlogs. Gains in net exports had contributed importantly to continued expansion over recent quarters. While further progress in reducing the nation's trade deficit was anticipated, some members emphasized the potentially adverse implications of a strengthening dollar for the nation's trade balance and domestic economic growth. On the whole, the economic expansion appeared to be stabilizing at a reduced but sustainable pace that tended to reflect both capacity constraints in some industries and some slowing in the growth of overall domestic demand.

With regard to the outlook for prices and wages, a number of members emphasized that inflationary pressures were still firmly rooted in the economy and that the rate of inflation might well remain unacceptably high for an extended period. However, the slowdown in economic growth should tend to moderate pressures on costs over time, and the most recent information on prices and wages had been encouraging. In addition, the overall outlook for agricultural production this year had favorable implications for food prices, and the recent strength of the dollar augured well for domestic inflation, albeit at the cost of reduced export opportunities. With respect to wages, some members commented that recent patterns were better than they had expected, given the persistence of tight labor markets in many areas and the low rate of unemployment for the nation as a whole. However, reference also was made to indications of greater militancy on the part of labor in some parts of the country and to a recent labor settlement that could have inflationary implications. On balance, in the context of slowing economic expansion, several members noted that the risks to the economy apparently had become less one-sided, having shifted from a strong potential for greater inflation to more equally weighted risks of higher inflation and a substantial shortfall in economic growth.

Turning to the conduct of monetary policy, nearly all of the members endorsed a proposal to maintain unchanged conditions of reserve availability, at least initially in the intermeeting period. There was considerable uncertainty as to whether monetary conditions were sufficiently restrictive to foster lower rates of inflation or had become so tight as to cause an even greater slowing in the expansion than might be needed to relieve inflation pressures. In the circumstances, most members viewed a steady policy as offering the best promise at this point of being associated with the financial market conditions and monetary growth rates that would support an appropriately restrained rate of economic expansion to accommodate the Committee's anti-inflationary objectives. Given current uncertainties, further developments would need to be evaluated carefully and might well call for some adjustment of policy, in either direction, before the next meeting of the Committee.

In the course of their discussion, the members took account of a staff analysis which indicated that unchanged reserve conditions were likely to be associated with some rebound in the growth of the monetary aggregates during the intermeeting period. Earlier increases in market interest rates in the context of typically sluggish adjustments of offering rates on relatively liquid consumer-type deposits had fostered slow growth in M2 and to a lesser extent in M3, while demand deposits had declined appreciably on balance since year-end. In recent weeks, transaction and other liquid accounts had been depressed further in conjunction with larger-than-expected tax payments and atypically small tax refunds. The staff analysis postulated some replenishment of tax-depleted deposits and a lessening impact from earlier increases in market rates on interest-sensitive deposit accounts, although there was as yet little evidence of a rebound.

In the light of indications of slower growth in business activity and sluggish monetary expansion which had left M2 well below the lower bound of its annual growth cone and M3 near the lower limit of its annual range, members attached considerable importance to the need for an upturn in monetary growth. Indeed, the behavior of the monetary aggregates would need to be monitored with special care over the weeks ahead, and a failure of monetary growth to revive during this period might well signal some further weakening in the business expansion and warrant a special consultation of the Committee. A pickup in M2 would be needed fairly soon to give some assurance that this aggregate was on a track that would bring it within the Committee's range for the year. In one view the monetary aggregates already were sufficiently weak to justify some immediate easing of reserve conditions in order to improve the prospects that adequate monetary growth would occur to sustain the economic expansion. Other members preferred a more cautious approach, in part to avert the potential need for, and resulting market unsettlement that would be associated with, a subsequent reversal of the easing, particularly if special factors depressing recent monetary growth were reversed.

With respect to possible adjustments in monetary policy during the intermeeting period ahead, a majority of the members supported a directive that would make an easing or a tightening of policy equally likely, depending on economic and financial developments and the behavior of the monetary aggregates. However, one member preferred a directive that was tilted toward ease in order to help assure a prompt policy response if monetary growth did not rebound relatively soon. Other members indicated a preference for retaining the previous intermeeting instruction that tilted more toward tightening than toward easing. Persisting inflationary pressures and, in this view, the still tentative indications of a slower business expansion argued for a continuing bias toward restraint. Some members were concerned that, under prevailing circumstances, a move to a symmetrical directive could be misinterpreted, when published, as a lessening of the Committee's commitment to an anti-inflationary policy.

During the Committee's discussion, consideration was given to the technical relationship between the level of adjustment plus seasonal borrowing and that of the federal funds rate. In comparison with experience in earlier years, borrowing had been low for some time in relation to the federal funds rate. However, the shortfall appeared to have diminished in recent weeks--largely because of a surge in seasonal borrowing--and, according to a staff analysis, unchanged reserve conditions over the upcoming intermeeting period might encompass somewhat higher average borrowing. In light of the persisting uncertainties in the relationship between borrowing and the federal funds rate, the members accepted the need for continued flexibility in the conduct of open market operations.

At the conclusion of the Committee's discussion, all but one of the members indicated that they favored or could accept a directive that called initially for no change in the degree of pressure on reserve positions. Some firming or some easing of reserve conditions would be acceptable during the intermeeting period depending on indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets. The reserve conditions contemplated by the Committee were expected to be consistent with growth of M2 and M3 at annual rates of around 1-1/2 and 4 percent respectively over the three-month period from March to June. The members agreed that the intermeeting range for the federal funds rate, which provides one mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 8 to 12 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 the rate of economic growth has slowed in recent months. Gains in total nonfarm payroll employment moderated substantially in March and April, and employment in manufacturing was about unchanged over the two months. The civilian unemployment rate rose considerably to 5.3 percent in April. Industrial production increased in April after declining on balance in the preceding two months. Growth in consumer spending has slowed considerably in recent months. Housing starts declined further in April. Recent indicators of business capital spending show a rebound after a decline in the fourth quarter. The nominal U.S. merchandise trade deficit was smaller on average in January and February than in the fourth quarter. Broad measures of prices have risen somewhat more rapidly in 1989, with a significant contribution from sharp increases in energy prices.
>
> Interest rates have declined considerably since the Committee meeting in late March. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose further on balance over the intermeeting period.
>
> Growth of M2 and M3 was sluggish in April, primarily because of a sizable decline in transactions balances. Through April, expansion of M2 has been at a rate below the Committee's range for the year, while growth of M3 has been in the lower portion of its range.
>
> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 3 to 7 percent and 3-1/2 to 7-1/2 percent, respectively, measured from the fourth quarter of 1988 to the fourth quarter of 1989. The monitoring range for growth of total domestic nonfinancial debt was set at 6-1/2 to

10-1/2 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of movements in their velocities, developments in the economy and financial markets, and progress toward price level stability.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, somewhat greater reserve restraint or somewhat lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth of M2 and M3 over the period from March through June at annual rates of about 1-1/2 and 4 percent, respectively. 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 8 to 12 percent.

Votes for this action: Messrs. Greenspan, Corrigan, Angell, Guffey, Heller, Johnson, Keehn, Kelley, LaWare, Ms. Seger, and Mr. Syron. Vote against this action: Mr. Melzer.

Mr. Melzer dissented because he favored an immediate move to slightly less pressure on reserve positions. While inflation was currently too high and might move even higher in the short run, he felt that the monetary policy restraint of the past two years would eventually reduce inflationary pressures. In addition, he was concerned that the very restrictive monetary policy of recent quarters, evidenced by extremely sluggish growth of reserves, the monetary base, and the monetary aggregates, heightened the risks of a recession unless the policy were to be reversed soon. In the event of a recession, a policy response aimed at a quick recovery could make the longer-term goal of price stability even more difficult to attain.

2. Foreign Currency Authorization.

At this meeting the Committee approved an increase in the limit on holdings of foreign currencies in the System Open Market Account. Paragraph 1D of the Committee's Authorization for Foreign Currency Operations permitted the Federal Reserve Bank of New York, for System Open Market Account, to maintain an overall open position in all foreign currencies not exceeding $12.0 billion. System holdings of such currencies had risen rapidly this year and totaled nearly $11 billion, based on historical costs. In light of the potential for further System acquisitions of foreign currencies in coordination with similar transactions by the U.S. Treasury and in cooperation with foreign monetary authorities, the Committee agreed to raise the limit in Paragraph 1D of the Authorization to $15.0 billion, effective immediately.

> Votes for this action: Messrs. Greenspan, Corrigan, Angell, Guffey, Heller, Johnson, Keehn, Kelley, Melzer, Ms. Seger and Mr. Syron. Vote against this action: Mr. LaWare.

Mr. LaWare dissented because he wanted to convey his skepticism about the effectiveness of sterilized intervention in foreign exchange markets. He did not object to the specific transactions that had been conducted recently.

Following the meeting the dollar remained under strong upward pressure which was resisted through very large additional System purchases of foreign currencies. Effective June 14, 1989, the Committee approved a further increase to $18.0 billion in the limit on System holdings of foreign currencies under Paragraph 1D of the Authorization for Foreign Currency Operations.

Votes for this action: Messrs. Greenspan, Corrigan, Angell, Guffey, Heller, Johnson, Keehn, Kelley, LaWare, Melzer, Ms. Seger, and Mr. Syron. Votes against this action: None.