FEDERAL RESERVE press release

For Use at 4:30 p.m. October 6, 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 August 22, 1989. This record also includes policy actions taken during the period between the meeting on August 22, 1989, and the next regularly scheduled meeting held on October 3, 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

RECORD OF POLICY ACTIONS OF THE FEDERAL OPEN MARKET COMMITTEE

Meeting Held on August 22, 1989

1. Domestic policy directive

The information reviewed at this meeting suggested that economic activity had continued to expand at a moderate pace in recent months. Job growth had remained sizable; and final demands, most notably in the consumer sector, appeared to be better maintained than had been indicated earlier. At the same time, price inflation had slowed, in large part reflecting a retracing of price increases in the food and energy sectors that had boosted inflation rates earlier this year; wage trends gave no signs of upward pressures.

Total nonfarm payroll employment rose appreciably further in July after a large advance in June. Most of the July increase took place at service establishments and in the construction industry where hiring had slowed during the first half of the year. Employment was little changed in manufacturing after three months of declines; much of the recent weakness had reflected layoffs in the automobile and electrical equipment industries. The civilian unemployment rate, at 5.2 percent, remained close to its average level in earlier months of the year.

Industrial production edged higher in July, offsetting the decline of the two previous months and continuing the general pattern of slow growth since the beginning of the year. Output of capital equipment posted another strong gain in July. Production of motor vehicles and parts declined substantially, but output of other consumer goods continued to rise at a moderate pace. Production of materials rebounded after declining on balance over the first half of the year. Total industrial capacity utilization held steady in July at a relatively high level. In manufacturing, despite a pickup in primary processing industries, operating rates edged lower and were down appreciably since January.

Retail sales rose considerably in July, and revisions for earlier months suggested that consumer spending in the second quarter had not been as weak as previously estimated. Purchases of nondurable goods advanced appreciably further in July from the upward revised levels of recent months. With a new round of manufacturers' incentives boosting sales of motor vehicles, spending on durable goods also increased. Housing starts rose slightly further in July following a large gain in June. The upturn in starts occurred in the wake of a bounceback in sales of both new and existing homes that was associated with the sizable decline in mortgage rates since April.

Recent indicators of business capital spending suggested some slowing of growth from the substantial pace of earlier months in the year. In June, shipments of nondefense capital goods increased modestly as a brisk rise in outlays for aircraft and computers outweighed a sharp decline in spending for other categories of producers' durable equipment. Nonresidential construction activity, led by stepped-up outlays for industrial structures, advanced strongly for a second consecutive month. Inventory investment in manufacturing and trade slowed in June to a pace well below the average rate of increase observed earlier in the year. In the manufacturing sector, inventories of most types of finished goods rose only moderately, while stocks of materials declined further. Inventories of work-in-process in the aircraft industry continued to grow, as the industry expanded production to keep pace with mounting orders. At the retail level, dealer stocks of automobiles rose a bit further. Inventories at other retail establishments also increased, but imbalances with sales appeared to be limited.

In June, the nominal U.S. merchandise trade deficit narrowed considerably, and for the second quarter as a whole it was about unchanged from a substantially reduced average value in the first quarter. Exports rebounded in June as increases in both capital and consumer goods outweighed a further decline in sales of agricultural goods. Imports declined appreciably, largely because of a drop in the value of oil imports. In the major foreign industrial countries, economic growth slowed significantly in the second quarter, following exceptionally rapid expansion in the first quarter.

Partly reflecting further sharp declines in consumer energy prices, producer prices of finished goods fell in July for a second consecutive month. Prices of finished consumer goods other than food and energy also declined, while prices of capital goods held steady. Apart from food and energy, prices of materials had fallen somewhat on balance at the intermediate level in recent months and had come down markedly at the crude stage. Consumer prices rose modestly in June after increasing sharply in earlier months of the year. Lower prices were registered for gasoline, fuel oil, and electricity; and consumer food prices rose more slowly. Prices of consumer services continued to advance in June at about the rate observed over the past year and a half. Average hourly earnings jumped in July after showing little change in the previous two months, and on balance the data for recent months suggested no change in prevailing wage trends.

At its meeting on July 5-6, the Committee adopted a directive that called for a slight reduction in the existing degree of pressure on reserve positions. The Committee agreed that somewhat greater or somewhat lesser reserve restraint would be acceptable in 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. This policy stance was expected to be consistent with growth of M2 and M3 over the period from June through September at annual rates of about 7 percent.

Immediately after the Committee meeting, the Manager for Domestic Operations conducted operations to achieve the slight easing in reserve conditions that the Committee had directed. At the same time, to reflect strength in seasonal borrowing, a small technical upward revision was made to the assumed level of adjustment plus seasonal borrowing. Late in July, as incoming data continued to portray a softer economy and some lessening in inflationary pressures, the Manager sought a further slight reduction in the degree of pressure on reserve positions. Adjustment plus seasonal borrowing averaged nearly $600 million over the three reserve maintenance periods completed since the July 5-6 meeting, while the federal funds rate moved down a little more than 1/2 percentage point to around 9 percent.

Other market interest rates fluctuated over a wide range during the intermeeting interval. Early in the period, rates tended to decline in response to weaker-than-anticipated economic data and related market expectations of further monetary easing. Subsequently, rates rebounded after the release of other economic indicators that were viewed as suggesting less weakness in the expansion and therefore a reduced likelihood of further easing. As a result, most rates ended the period with only modest net changes. Treasury bill rates were up about 1/4 percentage point on balance, while private short-term interest rates declined by roughly 30 basis points, and major banks lowered their prime rate 1/2 percentage point to 10-1/2 percent. In long-term debt markets, yields were about unchanged to slightly higher over the period. Most major stock price indexes reached record highs during the intermeeting period before giving up part of their gains.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies moved lower on balance through July as interest rate differentials favorable to the dollar were narrowing. In August, the dollar resumed its upward climb, spurred by continued political uncertainties abroad and a reassessment by market participants of the outlook for U.S. interest rates in light of a spate of new economic data. Over the intermeeting period as a whole, the dollar rose but at the end of the period remained below the highs of last June.

Growth of M2 and M3 accelerated in July and appeared to have continued at a fairly strong pace into August, evidently reflecting both the rebuilding of balances drawn down to meet April tax liabilities and the substantial narrowing of opportunity costs associated with holding liquid deposits. Through July, expansion of M2 had been around the lower end of the Committee's annual range, and M3 remained somewhat above the lower bound of its range.

The staff projection prepared for this meeting suggested that the nonfarm economy was likely to grow over the remainder of 1989 at about the pace estimated for the first half of the year but that some slowing of the expansion would occur in 1990. The projection assumed that fiscal policy would move noticeably toward restraint over the projection period and that the contribution of foreign trade to growth would be very limited, owing in part to the earlier appreciation of the dollar. Consumer demand was likely to be somewhat stronger over the next several quarters, bolstered by continued job growth and reflecting the ongoing effects on consumer sentiment of the advance in stock prices this year and the declines in interest rates since spring; in subsequent quarters, gradually mounting slack in labor markets would exert a restraining effect on consumer spending. The lower levels of interest rates also were expected to produce some pickup in residential construction activity. Growth in business capital spending, although moderating somewhat from the pace in the first half of the year, was projected to remain a source of strength. The recent weakening in food and energy prices pointed to a slower rise in consumer prices for the next few quarters; however, with margins of unutilized labor and other production resources still low, the underlying trend in inflation was not expected to improve through 1990.

In the Committee's discussion of the economic situation and outlook, members observed that indicators of business activity looked somewhat stronger on balance than at the time of the July meeting and that, despite some earlier concerns about a progressive slowdown, the economy appeared to be continuing to grow at a moderate pace. Several commented that further expansion at a rate close to that experienced recently was a reasonable expectation for the next several quarters and would constitute a desirable economic performance under prevailing circumstances. A number of members noted that there were no major imbalances in the economy of the sort that often lead to a recession or to a surge in business activity. However, because of the uncertainties that were involved, the members differed to some extent in their views regarding the risks of some deviation in the expansion from its present course; some felt those risks were about evenly balanced or were tilted toward some strengthening in the months ahead; several others saw some weakening as the most likely prospect, or at least the one that had to be guarded against because of the broad economic and social consequences of a downturn in economic activity. No member anticipated a sharp turn in the economy in either direction. The members also differed to some degree in their views on the outlook for inflation. Recent developments provided a basis for some optimism, but progress in reducing the underlying rate of inflation would depend importantly on the strength of the business expansion and also on the behavior of the dollar in foreign exchange markets.

In their discussion of specific developments bearing on the economic outlook, members noted that consumer spending appeared to have strengthened somewhat in recent months and most members expected such spending to hold up, or possibly to increase somewhat further, in the months ahead. Others placed more weight on the possibility that further gains, if any, might be relatively limited, in part because they expected automotive sales to be curtailed by higher prices and lower rebates when the new model year began. In the housing sector, current conditions were quite uneven across the country, with an increasing number of areas showing weakness, and the outlook was clouded to an extent by the possible effects of the disposition of properties in conjunction with the resolution of insolvent savings and loan associations. However, recent declines in mortgage rates would help to sustain the overall demand for houses. Should housing markets weaken, for whatever reason, the effect could be to depress not only construction activity but consumption spending as well. In the business investment sector, current demand conditions appeared consistent with further growth in overall investment spending, though probably at a much reduced pace from that experienced in the first half of the year, especially given the likely weakness in construction activity in many areas because of earlier overbuilding. With regard to the outlook for foreign trade, members emphasized that the strength of the dollar could have negative implications for the nation's trade prospects, and several expressed the view that further improvement in the trade balance, if any, was likely to be limited over the next several quarters; on the positive side, reports suggested that export markets remained relatively robust for many products.

In their comments on regional business conditions and business attitudes, members reported a somewhat mixed picture, depending on the industries that were involved. On balance, most parts of the country continued to experience a high level of business activity or at least modest further improvement from relatively depressed conditions. However, signs of somewhat slower growth had become more widespread and there were indications that business activity might have leveled out or turned down in some areas. Many business contacts appeared to be more bearish on the outlook than they had been earlier. In general, these contacts expected the overall economy to settle into a pattern of relatively slow growth. Few expressed concern about a possible decline in business activity.

In their comments on the outlook for inflation, members noted that the behavior of key price and wage measures in recent months was an encouraging development. From the perspective of cost pressures, the prices of many materials had increased less rapidly or had actually declined in recent months, and increases in labor compensation had been relatively moderate despite still tight labor markets in many parts of the country. While a number of members observed that little or no progress had been made thus far in reducing the underlying rate of inflation, most remained confident that the currently restrained growth in overall economic activity had established the necessary conditions for lowering inflation and achieving the Committee's price stability objective over time. Some anticipated that favorable inflation results might well emerge sooner rather than later. For some others a troubling question remained as to whether significant progress in reducing inflation was possible with the current degree of pressure on production resources. In this connection, a few expressed concern that some intensification of labor-cost pressures could not be ruled out under current economic conditions, and they noted in particular that there were indications of growing labor militancy in some industries and parts of the country. The strength of the dollar appeared to have damped inflation, but that effect would be reversed if the dollar were to depreciate substantially in foreign exchange markets.

Turning to the conduct of monetary policy, all of the members supported a proposal to maintain unchanged conditions of reserve availability at least initially during the intermeeting period ahead. The easing steps implemented since early June had been appropriate in the context of earlier indications of some slowing in the business expansion and a prospective lessening of inflation pressures. Partly as a consequence of the easing in policy, growth of the monetary aggregates had picked up, and both M2 and M3 were within the Committee's ranges for the year. For the period ahead, a steady policy course was desirable in light of the latest evidence suggesting that price pressures were not intensifying; in addition, the expansion appeared to have stabilized at a moderate and provisionally acceptable pace and considerable uncertainty existed with regard to the timing and direction of future deviations from the expansion's current momentum. Some members commented on indications that financial markets anticipated some further easing of monetary policy in the months ahead, if not immediately. If such easing failed to materialize, the result could be some upward adjustments in interest rates that could have an adverse impact on interest-sensitive sectors of the economy such as housing and that could place undesirable upward pressure on the value of the dollar in foreign exchange markets. Despite such concerns, the members agreed that for now an unchanged policy offered the best prospects of fostering the financial market conditions and the monetary growth that would accommodate satisfactory economic performance. They recognized that economic developments would have to be monitored closely to assess whether any change in policy might be needed.

In their consideration of an appropriate policy course, the members took account of a staff analysis indicating that the expansion of M2 and M3 was likely to slow substantially from the recent pace but to remain well within the Committee's ranges for the year. The analysis took note of the decline in market interest rates over the past several months and assumed that the latter would stabilize at current levels and that the expansion of nominal income would remain near its recent pace. The outlook for money growth was subject to unusual uncertainty, however, stemming from the range of possible responses by thrift depository institutions to the recently enacted legislation and associated government strategy for resolving insolvent institutions. The expansion of M3 would be slowed as savings and loan associations reduced their funding needs by selling assets or curbing the growth of assets; the expansion of M2 might also be affected depending on the impact of these developments on deposit offering rates and related opportunity costs of holding deposits. Any weakness in money growth for these reasons, however, would not be an indication of a slowing economy, given the presumption that highly developed secondary markets would maintain the availability of mortgage credit. Members commented that despite its recent acceleration, monetary growth remained damped when measured over a longer period, suggesting a basically restrained monetary policy. While continued monetary expansion at the recent rapid pace clearly would be undesirable in a period when underlying inflation was unacceptably high, a renewed shortfall in relation to the Committee's ranges also should be averted.

With regard to possible adjustments in the degree of reserve pressure in the intermeeting period, a majority of the members believed that operations should be adjusted more readily toward further easing than toward any firming and a few indicated that they viewed the incorporation of such an understanding as a key element of an acceptable directive. While most members anticipated that a steady policy course might well prove to be appropriate for the entire intermeeting period, any adjustment called for by prospective developments was more likely to be, in the majority view, in the direction of some reduction in the degree of reserve restraint and such an expectation should be reflected in the directive. Most of the other members indicated that they could accept such a directive, but because they believed that the risks to the economy were more evenly balanced, they favored a directive that did not include a presumption as to the likely direction of any intermeeting adjustments. These members also noted that the current directive was symmetric in form and a bias in the new directive toward ease might lead to a misreading of System policy in the context of an unacceptably high rate of inflation.

At the conclusion of the Committee's discussion, all but one of the members indicated that they preferred or could accept a directive that called for maintaining the current degree of pressure on reserve positions and that provided for giving special weight to potential developments that might require some slight easing during the intermeeting period. With regard to the factors that were important in considering any intermeeting changes in reserve conditions, the Committee continued to give primary weight to the inflation outlook. In that regard, they emphasized that policy actions ought to be consistent with furthering achievement of the ultimate objective of price stability. Accordingly, slightly greater reserve restraint might be acceptable during the intermeeting period, while some slight lessening of reserve pressure would be acceptable, depending on progress toward price stability, 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 9 percent and around 7 percent respectively over the three-month period from June to September; in the case of M2, such growth was somewhat faster than that anticipated at the time of the July meeting. The intermeeting range for the federal funds rate, which provides one mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, was left unchanged at 7 to 11 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 has continued to expand at a moderate pace in recent months. In July, total nonfarm payroll employment rose appreciably further after a large advance in June, and the civilian unemployment rate, at 5.2 percent, remained close to its average level in earlier months of the year. Industrial production edged higher in July, continuing the slower growth observed since the beginning of the year. Retail sales have grown at a moderate pace in recent months. Housing starts rose slightly further in July following a large gain in June. Recent indicators of business capital spending suggest slower growth after the substantial increase in the first half of the year. The nominal U.S. merchandise trade deficit narrowed considerably in June and for the second quarter as a whole was about unchanged from a substantially reduced average value in the first quarter. Partly reflecting reductions in energy prices, increases in consumer prices moderated in June and July. The latest wage data suggest no change in prevailing trends.

Interest rates show mixed changes on balance since the Committee meeting on July 5-6. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies has risen on balance over the intermeeting period.

M2 and M3 grew markedly in July, lifting expansion of M2 thus far this year to around the lower end of the Committee's annual range, and keeping M3 somewhat above the lower bound of the Committee's 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 July reaffirmed the ranges it had established in February 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 also was maintained at 6-1/2 to 10-1/2 percent for the year. For 1990, on a tentative basis, the Committee agreed in July to use the same ranges as in 1989 for growth in each of the monetary aggregates and debt, measured from the fourth quarter of 1989 to the fourth quarter of 1990. 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 progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, slightly greater reserve restraint might or slightly 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 June through September at annual rates of about 9 and 7 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 7 to 11 percent.

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

Mr. Guffey supported an unchanged policy for the period ahead, but he could not accept a directive that would allow possible intermeeting adjustments to be made more readily in an easing than in a firming direction as new information became available. In his view, the risks to the expansion were fairly evenly balanced and did not warrant an asymmetric directive biased toward ease, especially in light of undesirably high rates of inflation both current and prospective. He also noted his concern that a directive tilted toward ease could give a misleading indication of the weight that the Committee continued to place on achieving its long-run price stability objective.

2. <u>Authorization for Foreign Currency Operations.</u>

As part of a proposed multilateral bridge financing facility for Mexico, the Committee approved a special reciprocal currency arrangement of $125 million with the Bank of Mexico. The new facility supplements the regular $700 million arrangement with the Bank of Mexico set out in paragraph 2 of the Authorization for Foreign Currency Operations. The Committee delegated to Chairman Greenspan the authority to approve a drawing on both of these arrangements by the Bank of Mexico, subject to his determination that the appropriate terms and conditions had been met.

Under the terms of the multilateral facility, the Bank of Mexico may draw up to $2 billion in short-term financing in support of the program of the Government of Mexico for economic reform and economic growth. Participating with the Federal Reserve in making funds available are the U.S. Treasury through its Exchange Stabilization Fund, central banks from the other Group of Ten countries acting under the aegis of the Bank for International Settlements, and the Bank of Spain. The final maturity date of the facility is February 15, 1990.

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

On September 14, 1989, the multilateral bridge financing facility became effective and on September 22, 1989, Chairman Greenspan, acting under the delegation of authority from the Committee, gave final clearance for drawings by the Bank of Mexico on the reciprocal currency arrangements.

3. <u>Agreement to "Warehouse" Foreign Currencies</u>

On September 19, 1989, the Committee agreed to a request by the Treasury for an increase from $5.0 billion to $10.0 billion in the amount of eligible foreign currencies that the System would be prepared to "warehouse" for the Treasury and the Exchange Stabilization Fund (ESF). The warehousing facility involves spot purchases of foreign currencies from the Treasury or the ESF and simultaneous forward sales of the same currencies at the same exchange rate to the Treasury or the ESF. Such transactions are authorized under Paragraphs 1.A and 1.B of the Committee's "Authorization For Foreign Currency Operations," and the maximum size of the facility is determined periodically by the Committee; the most recent change involved an increase from $1-3/4 billion to $5.0 billion in December 1978. The proposed increase was intended to enable the ESF to finance its continued participation in foreign currency operations.

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

Effective September 25, 1989, the Committee approved an increase from $18 billion to $20 billion in the limit on holdings of foreign currencies specified in paragraph 1D of the Committee's Authorization for Foreign Currency Operations. That limit applies to the overall open position in all foreign currencies held in the System Open Market Account; at the time of this action, System holdings had reached nearly $18 billion. The higher limit was approved in light of the potential for further System acquisitions of foreign currencies in coordination with similar transactions by the U.S. Treasury. In approving the increase, the Committee took account of the views expressed by the Finance Ministers and Central Bank Governors of the Group of Seven countries at their meeting on September 23, 1989. These officials considered the rise of the dollar in recent months to be inconsistent with longer-run economic fundamentals and they agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy. In this context, they agreed to cooperate closely in exchange markets.

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

In dissenting from this action, Messrs. Angell and Johnson indicated that they could not consent to an increase in the authorized limits for holding foreign currencies when such authorization facilitates exchange rate intervention to drive the dollar lower as compared with intervention to avoid disorderly conditions by stabilizing or limiting increases in the dollar exchange rate. Intervention of the former type confuses market participants concerning the policy commitment toward price level stability and can contribute to disorderly markets. It can increase inflation fears as can be seen in decreases in long-term bond prices and in increases in the price of inflation-sensitive commodities. Interest rate risk premiums also may increase. Finally, such intervention can work to limit flexibility in the exercise of fundamental monetary policy options that depend on evidence of improvement in the future inflation environment.