FEDERAL RESERVE press release

For Use at 4:30 p.m.

February 9, 1990

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 18-19, 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 December 18-19, 1989

1. Domestic policy directive

The information reviewed at this meeting suggested that economic activity was expanding slowly in the fourth quarter, with the moderation from earlier in the year only partly attributable to strikes and other special factors. Abstracting from these factors, the growth of final demands had slowed, and the effects were especially evident in the manufacturing sector. By contrast, growth of the service sector appeared to be well sustained, and overall construction activity seemed relatively firm. Broad measures of inflation indicated that prices had risen more slowly on balance since midyear, partly reflecting sharp reductions in energy prices; recent wage data suggested no significant change in prevailing trends.

Total nonfarm payroll employment rose appreciably in November after a small gain in October. All of the November increase occurred at service, trade, and financial establishments. Job losses continued in manufacturing, especially in motor vehicle and related industries, but cutbacks were evident elsewhere, notably in electrical machinery. The civilian unemployment rate edged up to 5.4 percent in November, its highest level since January.

Industrial production rose slightly in November after a sizable decline in October that resulted from strike activity and other disruptions; adjusting for these temporary influences, production was down slightly, on balance, in recent months. Output of consumer goods

declined in November as production of durables other than motor vehicles dropped sharply further. Output of business equipment increased appreciably, owing in part to a recovery in the production of computers in the aftermath of the earthquake in the San Francisco area. Total industrial capacity utilization slipped a bit in November and was nearly 1-1/2 percent below its level a year earlier.

Nominal retail sales in November partially retraced the sharp October decline; sales for the month were little changed from the third-quarter average, reflecting continued weakness in motor vehicles. Outside of vehicles, sales rebounded for a wide range of goods, especially for apparel items. Housing starts declined in November as construction of multifamily units fell back to about the average pace that had prevailed since April. However, for the October-November period, starts were up somewhat on average from their third-quarter level because of a pickup in single-family units.

Recent indicators of business capital spending suggested a weakening in expenditures after a substantial increase earlier in the year. Shipments of nondefense capital goods fell in October for a second straight month. Part of the October decline stemmed from the effects of the strike at Boeing on shipments of aircraft; small declines were widespread elsewhere, and a considerable drop occurred in computing equipment. The orders data for October suggested continued weakness in equipment outlays in the near term. Nonresidential construction activity posted another gain, led by a sizable increase in non-office commercial construction; however, office vacancy rates, construction permits, and other indicators pointed to renewed weakness. Total

manufacturing and trade inventories rose in October at about the third-quarter pace. Accumulation of manufacturing inventories was moderate, and stocks remained at relatively low levels compared to shipments. Stocks at wholesalers jumped but, in relation to sales, remained in the middle of the range that has prevailed over the past two years. Retail inventories fell appreciably in October, reflecting a large decline in auto dealers' stocks. Excluding auto dealers, the retail inventory-sales ratio increased in October to a level well above its range over the past year.

The nominal U.S. merchandise trade deficit widened appreciably in October from an upward revised September rate. Much of the widening reflected a sharp increase in imports of industrial supplies, notably paper, steel, and textiles. The value of exports showed a small increase for the third straight month as larger shipments of automotive products and other industrial goods outweighed a substantial decline in exports of aircraft. Indicators of economic activity in the major foreign industrial countries suggested a mixed performance in the third quarter, although growth remained fairly strong on balance. Economic growth appeared to have rebounded strongly in Japan and, adjusted for special factors, to have remained firm in Germany.

Producer prices for finished goods edged down in November after sizable increases in the previous two months and, on balance, had risen at lower rates since midyear. Prices of finished energy products, especially gasoline, fell sharply; the drop more than offset a second month of increases in finished food prices. Consumer prices excluding food and energy items rose a little faster in October and November than

in other recent months. Over the October-November period, food prices were boosted by sharp increases in dairy products, meats, and fresh produce while the rise in energy prices was held down by a net decline in the price of gasoline. Average hourly earnings slipped in November, and the large increase initially reported for October was revised downward. However, the results of recent collective bargaining activity suggested a continuation of the larger wage settlements evident earlier in the year.

At its meeting on November 14, the Committee had adopted a directive that called for maintaining the existing degree of pressure on reserve positions and that provided for giving special weight to potential developments that might require some easing during the intermeeting period. The availability of reserves had been eased slightly earlier in November. With regard to the intermeeting period ahead, the Committee had agreed that slightly lesser reserve restraint would be acceptable, or slightly greater reserve restraint might 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 contemplated reserve conditions were expected to be consistent with growth of M2 and M3 over the period from September through December at annual rates of about 7-1/2 percent and 4-1/2 percent respectively.

In the period since the November meeting, the Manager for Domestic Operations had directed open market transactions toward maintaining an unchanged degree of reserve availability. Conditions in reserve markets softened temporarily around Thanksgiving when operations

to meet seasonal reserve needs were misread as signaling a further easing of monetary policy. Over most of the intermeeting period, however, federal funds traded around 8-1/2 percent, the level prevailing at the time of the mid-November meeting. Adjustment plus seasonal borrowing fell to an average of around $150 million in the first half of December. To reflect a continuing decline in seasonal borrowing, technical reductions were made at the start of the intermeeting period and in the second week of December in the assumed level of adjustment plus seasonal borrowing used in constructing the target paths for the provision of reserves.

Against the background of an unchanged monetary policy and incoming information that generally was viewed as consistent with expectations of continuing but slow growth in economic activity, most market interest rates changed little on balance over the intermeeting period. Major indexes of stock prices generally rose over the period. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies fell substantially despite some easing of short-term interest rates in Germany and Japan. The decline of the dollar primarily reflected the buoyancy of the German mark as exchange market participants interpreted political developments in Eastern Europe as having favorable implications for the German economy. The dollar declined somewhat less against other European currencies linked to the mark in the European Monetary System and was little changed against the yen.

Growth of the broader monetary aggregates accelerated somewhat further in November and remained robust in early December, despite a

contraction in demand deposits that resulted in considerably slower expansion of M1. The expansion of M2 continued to reflect the effects of earlier reductions in market interest rates and related opportunity costs, and it seemed likely that the velocity of M2 would decline substantially further in the fourth quarter. Assets of thrift institutions and their associated funding needs apparently continued to contract, keeping growth of M3 below that of M2, but the decline seemed to be at a reduced pace and in November M3 grew at its fastest rate since the summer. Through November, M2 had expanded at a pace near the midpoint of the Committee's annual range while M3 had grown at a rate a little above the lower bound of its annual range.

The staff projection prepared for this meeting continued to suggest that the economy would expand at a reduced pace over the next several quarters. Growth in the first quarter was expected to rebound from temporary disturbances to production stemming from strike activity and natural disasters in the fourth quarter, although the extent of the rebound would be limited by further reductions in the production of motor vehicles in the early months of the year. Over the remainder of 1990, a relatively moderate expansion in consumer spending was projected to be a key factor in sustaining overall demand and production. Business outlays for fixed investment also were expected to increase, but at a much reduced pace in an environment of slow revenue growth and deteriorating cash flows. Housing construction was forecast to expand at a relatively sluggish pace over the course of the year. The projection continued to assume that the federal budget deficit would decline moderately and that net exports would make little contribution

to domestic economic growth in 1990. Pressures on labor and other production resources were expected to ease only marginally and the underlying trend of inflation was not projected to change significantly.

In the Committee's discussion of the economic situation and outlook, members emphasized that signs of a weaker expansion had accumulated and that the economy was likely to remain sluggish at least over the near term. While most members agreed that further economic growth was a reasonable expectation for the year ahead, several observed that recent developments suggested greater risks in the direction of a weaker economic performance. These members expressed concern that problems in some sectors of the economy such as motor vehicles and commercial and residential real estate might lead to greater caution in credit extensions and overall spending, especially given indications of some deterioration in business confidence, and to more widespread softening in the economy. Other members saw more favorable prospects for some strengthening of the expansion next year, though they did not anticipate a strong rebound in economic activity. These members recognized that there were imbalances in the economy but they felt that, among other developments, prevailing patterns in orders and production, though softening, were not inconsistent with somewhat faster economic growth once current difficulties such as those in the automobile industry were worked through and the effects of the monetary policy easing over the past half year were felt more fully. It also was noted that certain forward-looking indicators, including commodity prices, monetary growth, foreign exchange rates, and the Treasury yield curve, were consistent with some pickup in economic expansion next spring.

With regard to the outlook for inflation, those who believed the risks were on the side of a weaker economy and less pressure on production resources generally saw favorable prospects for further progress toward price stability next year. Some of the members who expected a somewhat stronger economy were less optimistic about the extent of such progress, if any, but they also believed that there was little risk of a pickup in the underlying rate of inflation.

In the course of the Committee's discussion, members reported more sluggish business conditions in a number of areas and some loss of business confidence, but overall economic activity appeared to be continuing to grow in most, if not all, parts of the country. With some notable exceptions, manufacturing activity had moderated across the country, with particular weakness in the production of motor vehicles, other durable consumer goods, and some types of capital equipment. Members observed that conditions in the automobile industry probably would continue to have a negative effect on overall economic activity in the months ahead, and some noted that the longer-term outlook was difficult to predict because structural problems related to changing demand patterns appeared to be involved. Construction activity also was cited as a source of weakness in many areas, though it remained relatively robust in others. In general, nonresidential construction seemed likely to be damped by overcapacity in office and other commercial structures. Overall demand for new housing appeared to be essentially flat, though with considerable local variations, despite earlier declines in mortgage interest rates. It was noted that the availability of financing for the construction of housing appeared to

have been reduced by tighter supervisory regulations and some decrease in the number of traditional institutional lenders to this industry. In addition, the availability of such financing appeared to have been adversely affected by the weakness of real estate markets in a number of areas and the large resulting losses on loans.

On a more positive note, a number of members commented that consumer spending was likely to be sustained by continuing gains in incomes and the ample liquid assets of households that were available to support greater spending. Consumer spending on services was likely to continue to grow. The outlook for retail sales was somewhat uncertain, including at this point the still very limited information on holiday sales, but outside the most depressed areas retailers appeared to be relatively optimistic. The recent depreciation of the dollar would tend over time to boost overall demand and economic growth. More generally, the recent slowing in the expansion could be attributed in part to special or temporary factors and to the lagged effects of the tightening of monetary policy through early 1989. On the whole, current demand conditions were not seen by most members as suggesting a cumulative weakening in the economy.

With regard to the outlook for inflation, the views of the members continued to differ to some extent. Several anticipated that little or no progress was likely to be made in reducing inflation over the year ahead, in part because the effects of the recent decline of the dollar would tend to offset expected gains from diminished pressures on labor and other production resources. Some of these members also expressed concern that a possible resumption of economic growth at a

pace closer to the economy's potential, perhaps later next year, would reverse any tendency for inflation to decline. Other members were somewhat more optimistic about the outlook for prices and wages. Some commented that they were encouraged by the performance of prices in the second half of 1989, and a number cited the strong competition for many products from both domestic and foreign producers, the behavior of industrial materials and commodity prices, and the growth of capacity in some key industries.

In the Committee's discussion of monetary policy for the intermeeting period ahead, the members focused on the possible need to ease reserve conditions slightly further to provide greater assurance that weaknesses in demand did not persist or deepen. The current slowdown in economic growth was to a considerable extent the result of the policy implemented much earlier to restrain emerging inflation pressures, and this policy seemed at least to have avoided an upsurge in inflation. Over time, a further damping of price pressures was needed if the economy was to realize the benefits of price stability, but that need not involve a downturn in the economy. Several members observed that the choice between some slight easing at this time or waiting for additional evidence that the economy might be weakening further was a close one. A majority indicated that on balance they viewed the risks of a shortfall in economic activity as sufficiently high to justify an immediate move to slightly easier reserve conditions, and one member expressed a preference for somewhat greater easing. In this regard, some noted that the next several months might be a critical period in terms of avoiding a recession and that some modest easing at this point

might have a calming effect on financial markets and help to boost business confidence. Given downward pressures on many prices and softness in business conditions, some slight easing was not likely in this view to be inconsistent with the long-run objective of price stability or the public's perception of the importance that the System placed on that objective. These members recognized that an easing of reserve pressures immediately after the meeting would make the need for further easing less likely over the coming intermeeting period. As a consequence, they favored a directive that did not contain a tilt toward less restraint but one that gave equal weight to potential intermeeting adjustments in either direction.

Members who supported an unchanged policy commented that current reserve conditions appeared to be consistent with ongoing expansion in business activity at a pace that over time would serve to moderate pressures on labor and other production resources, and they were concerned that further easing might overcompensate for current weaknesses in the economy at the cost of delaying progress toward price stability. In current circumstances, an easing also might foster some concern about the System's commitment to achieving price stability and put undesirable downward pressure on the dollar in the foreign exchange markets. At the same time, these members recognized the risk of some further weakening in the economy, and several favored a directive that incorporated a strong presumption that indications of such a development would trigger a prompt adjustment of reserve conditions. Most of these members were willing to accept a slight immediate move toward easier reserve conditions but, in that case, they doubted that any further

easing would be appropriate over the intermeeting period unless the economy, prices, or financial developments deviated very substantially from current expectations. Two members indicated that they could not accept any further easing at this time, in part because of their concerns about the consequences for growth of the monetary aggregates and, more generally, for inflation expectations and inflation over time.

Members referred to the strong growth of M2 over the past several months and took note of a staff analysis which concluded that such growth would remain fairly strong over months ahead if reserve conditions stayed unchanged or were eased slightly. Earlier declines in short-term interest rates and typically slow adjustments of offering rates on M2-type deposits had tended to make such deposits relatively more attractive by reducing the opportunity costs of holding them. The outlook for M3 was subject to considerable uncertainty, but growth of that aggregate was expected to remain below that of M2. The extent of the shortfall would depend in important measure on the degree to which solvent but capital-deficient thrift institutions continued to reduce assets to meet new capital requirements and on the extent of RTC activity in resolving insolvent thrift institutions.

At the conclusion of the Committee's discussion, all but two of the members indicated that they favored or could accept a directive that called for a slight easing of reserve conditions. In keeping with the Committee's usual approach to policy, the conduct of open market operations would be subject to further adjustment during the intermeeting period 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. On the basis of such developments, slightly greater or slightly lesser reserve restraint would be acceptable during the period ahead. The reserve conditions contemplated at this meeting were expected to be consistent with growth of M2 and M3 at annual rates of about 8-1/2 and 5-1/2 percent respectively over the four-month period from November 1989 through March 1990. In light of the easing of reserve conditions over the course of recent months and the further slight easing favored by a majority of the members at this meeting, the Committee decided to lower the intermeeting range for the federal funds rate by 1 percentage point to 6 to 10 percent. Such a reduction would center the range more closely around the average federal funds rate that was expected to prevail after this meeting.

At the conclusion of the Committee's 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 is expanding slowly in the current quarter. Total nonfarm payroll employment has increased at a reduced pace on average over the past several months, with declines continuing in the manufacturing sector. The civilian unemployment rate edged up to 5.4 percent in November. Industrial production rose slightly in November after a decline in October resulting from strike activity and other disruptions. Nominal retail sales excluding motor vehicles strengthened in November, but continued weak sales of vehicles held total retail sales for the month to a level that was little changed from the third-quarter average. Housing starts fell in November but for the October-November period were up somewhat on average from their third-quarter level. Indicators of business capital spending suggest a weakening in expenditures after a substantial increase earlier in the year. The preliminary data indicate that the nominal U.S. merchandise trade deficit widened appreciably in October from an upward revised

September rate. Broad measures of inflation suggest that prices have risen more slowly on balance since midyear, partly reflecting sharp reductions in energy prices, but the latest data on labor compensation suggest no significant change in prevailing trends.

Interest rates have changed little on balance since the Committee meeting on November 14. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined substantially over the intermeeting period, with a particularly pronounced depreciation against the German mark and related European currencies in the last week of the period.

M2 continued to grow fairly briskly in November, largely reflecting strength in its retail deposit components; M2 has expanded this year at a pace near the midpoint of the Committee's annual range. Growth of M3 picked up in November but has remained more restrained than that of M2, as assets of thrift institutions and their associated funding needs apparently continued to contract; for the year to date, M3 has grown at a rate a little above the lower bound of the Committee's annual 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 decrease slightly 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 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 November through March at annual rates of about 8-1/2 and 5-1/2 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 6 to 10 percent.

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

Messrs. Angell and Melzer dissented because they did not believe that policy should be eased. Mr. Angell was concerned that the Committee was responding to indicators of recent weakness in economic activity, a weakness that was a consequence of somewhat cautious policy responses earlier. Policy decisions should rely mainly on leading indicators, including commodity prices, the exchange rate, the yield curve, and money supply growth. Attention to such indicators had served policy well in the past. During the spring and summer while the dollar was appreciating and commodity prices, including gold, were generally falling, easing of reserve conditions was accompanied by the lower long-term interest rates necessary to undergird housing and other long-term investments. At this meeting, price-level indicators were not signalling a need for further ease. In these circumstances, an additional drop in the federal funds rate, coming after two previous

easing moves in the fourth quarter, could raise doubts about the System's commitment to its objective of price stability, especially given that the easing would further stimulate M2 growth. Under such conditions, further easing of reserve pressures would tend to accommodate rising prices, foster uncertainty in financial markets, and drive up long-term interest rates, thereby increasing the likelihood of economic instability. Steady policy in pursuit of price stability, using forward-looking indicators, would reduce uncertainty about price trends, bolster confidence in the dollar domestically and internationally, and bring about lower interest rates and higher economic growth.

Mr. Melzer dissented because he favored an unchanged degree of reserve restraint. He noted that policy had been eased considerably over the last six months in anticipation of prospective sluggishness in the economy and that ample liquidity was now being provided by the central bank. In addition, based on recent and projected growth in the monetary aggregates, he was concerned that long-term progress toward price stability would be jeopardized by a more accommodative short-run policy stance.

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 $20 billion, based on historical costs.

System purchases of foreign currencies, which were coordinated with similar transactions by the U.S. Treasury, had been relatively limited recently, but with the accumulation of interest total holdings were approaching the $20 billion limit. The Manager for Foreign Operations advised that even in the absence of new market purchases, continuing accruals of interest would raise total holdings to the current limit by February. The Committee agreed to raise the limit to $21 billion, effective immediately.

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