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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF MONETARY AFFAIRS

Date: April 3, 1995

To: Federal Open Market Committee

From: Donald Kohn

Subject: Change in Direction of Monetary Policy in 1989

Attached is the memorandum concerning the change in the direction of monetary policy in the spring of 1989 that I referenced in my briefing last week.

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DIVISION OF MONETARY AFFAIRS

Date:	April 3, 1995
To:	Mr. Reinhart
From:	Stephanie Schmitt-Grohé
Subject:	Change of Direction of Monetary Policy in June 1989

1. Introduction

This memo tries to reconstruct the factors that resulted in a change in the direction of monetary policy from tightening toward easing in the spring of 1989. While many new pieces of information contributed to the FOMC's assessment in June 1989 that inflationary pressures had become weaker, the behavior of the monetary aggregates and wages, as well as a general perception that the economy had slowed, played predominant roles. This judgment comes from reading the transcripts of the FOMC meetings that took place in the first half of 1989, namely on February 7-8, March 28, May 16, and July 5-6, as well as the transcripts of telephone conference calls on Wednesday May 31, and on Monday June 5, 1989, which preceded the easing of June 6, 1989.[1]

In May 1989, the federal funds rate was expected to trade around 9-3/4 to 9-7/8 percent. The Federal Reserve had tightened reserve market conditions about 3 percentage points over the prior twelve months. The last sizable tightening occurred on February 24, 1989, when the intended federal funds rate was increased 25 basis points, to 9-3/4 percent, in association with an increase in the discount rate. On June 6, 1989, the FOMC lowered interest rates 25 basis points, opening an easing phase that lasted until the end of 1992 (see Figure 1).

Tables 1 to 4 summarize the policy directives and the policy actions in the intermeeting periods of the four relevant FOMC meetings. As a preview, the domestic policy directive in February 1989 sought to maintain the existing degree of pressure on reserve positions and was asymmetric toward tightening. Over the intermeeting period the Board increased the discount rate 50 basis

[1] All of these transcripts have just been released to the public.

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points, to 7 percent, and the target federal funds rate rose a total of 75 basis points. The March directive also called for maintaining the current pressure on reserve conditions and was asymmetric toward tightening. There was no substantial change in money market conditions in the intermeeting period and no conference call.

The May directive was similar to the ones in February and March, in that it called for maintaining the current pressure on reserve markets, but it was also different because for the first time the directive contained symmetric language. Two weeks after the Committee met in May there were two conference calls. The day after the second call, on June 6, the federal funds rate was lowered 25 basis points. The July directive called for a further reduction in reserve pressures (of 25 basis points), and over the intermeeting period the intended federal funds rate was decreased by another 25 basis points. At the end of the July FOMC cycle, the federal funds rate was back down to 9 percent, where it had been at the February 7, 1989 FOMC meeting.

2. FOMC Meeting on May 16, 1989

The paths for the intended federal funds rate underlying the staff forecast in the February, March and also May 1989 Greenbooks were similar, in that all assumed that the federal funds rate would have to rise to 10-1/2 to 10-3/4 percent by the end of 1989 in order to relieve cost pressures and reverse the uptrend in inflation. The outlook presented in Part I of the May 10, 1989 Greenbook stated that

> ... aggregate demand has to moderate still further to relieve cost pressures and reverse the current uptrend in inflation. Consequently, we have assumed that policy will impose additional restraint, with interest rates rising further over the remainder of the year. (p. I-4, May 10, 1989 Greenbook).

Similar paragraphs can be found in the March and February Greenbook. This raises the question of what news or information made the FOMC adopt a symmetric directive in May 1989, whereas the two previous directives had been asymmetric toward tightening.

Opinions at that time appear to have been evolving fairly rapidly. There are several differences between the Outlook portion of the May Greenbook published on May 10, 1989 and the

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Economic Outlook given by the staff on May 16, 1989 at the FOMC meeting itself. The FOMC briefing opened by stating that the expansion of the economy has slowed and that

> ... indeed, the information received since last Wednesday [the publication date of the Greenbook] suggests that we may have underestimated in the Greenbook the degree of deceleration that has occurred thus far this year. (p.1, FOMC Briefing–Economic Outlook, May 16, 1989).

In light of incoming information, the staff now forecasted a period of slow growth, but not a recession. Among the data released after the Greenbook was published were retail sales figures. Staff had expected the level of sales to be much higher than it was. The most recent numbers showed that real retail sales had declined for three straight months. Industrial production was published on May 15 and was also weaker than expected, with first-quarter growth revised down from 3 percent to 2 percent. As a result, the staff indicated that the assumed future path of the federal funds rate might have to be lowered:

> ... I should note, in conclusion, that we have retained our forecast that the necessary monetary restraint will be associated with somewhat higher interest rates in the second half of this year. Admittedly, one's conviction on this score has to be tempered somewhat by the recent signs of greater economic weakness than we had projected. Perhaps the more crucial assertion that we would still want to make today is that, while a further rise in rates might not be necessary, a significant policy-induced decline in rates at this time likely would jeopardize the chances of restoring a disinflationary trend any time soon. (p.6, FOMC Briefing-Economic Outlook, May 16, 1989).

In the May 16, 1989 FOMC Financial Briefing, the staff had drawn attention to the somewhat unexpected slow growth of the monetary aggregates, in particular the behavior of M2. By May 8, the level of M2 had declined since the last FOMC meeting in March (which can be seen in Figure 2, which is just Chart 10 of the Financial Indicators package distributed at the May 16, 1989 FOMC meeting). The policy alternative adopted at the March 28, 1989 FOMC meeting had been projected to imply monthly growth of M2 in April and May of about 3 percent each, but the April M2 growth rate published in the May Bluebook was only 0.6 percent.[2] The statement of the

[2]This refers to the then-current M2 data. The annual benchmark and seasonal reviews have since smoothed away

staff further pointed out that real M2 growth on a four quarter moving average basis had recently turned negative for the first time since 1981 and that "... at least since 1959, any decrease in real M2 [on a four-quarter moving average basis] was a precursor of recession." (p.4, FOMC Briefing, May 16, 1989).

The staff predicted growth of M2 to pick up soon, because the current weakness was explained by several special factors that were assumed to no longer be important in the near future. This led to some discussion of monetary aggregates by several members of the FOMC. In his remarks starting off the round-table discussion Chairman Greenspan stated

> The one negative, which bothers me as much as it has bothered a number of people around here, is the money supply data. The evidence suggests, as Don [Kohn] points out, the money supply is coming back rather quickly. ... But if it fails to do so, then I think we'd better be looking very closely for other forms of evidence that might be signaling that the stability of the system which now seems to be in place is in fact lacking. ... I would be careful specifically to watch the money supply more closely than we usually do, although I'm not sure that I would recommend that we move it up in the directive. (p. 39, transcript of FOMC meeting on May 16, 1989).

Other members of the Committee questioned whether there was in fact any evidence at this time that money growth was coming back. It then was agreed upon that in case money supply did not grow as expected over the near future the Committee would have a telephone call or the Chairman would act.

Some FOMC members questioned the staff's assumption about the future path of the federal funds rate, citing the Blue Chip forecast which predicted lower short-term interest rates for the remainder of the year. Market expectations at that time seem to have been for lower short-term rates, as reflected in the increasing spread between the overnight federal funds rate and the three-month Treasury bill (see Figure 3) and a downward sloping yield curve (see Figure 4). Some FOMC members asked how the staff could reconcile their assumption about the future path of the federal funds rate with their projected path of M2. In the staff outlook, M2 growth was expected to pick up despite an interest rate increase in second half of the year. The argument made in response was

some of these changes.

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that effects of the interest rate increases at the beginning of year were already digested and that the rate increases to come at the end of 1989 would not affect the 1989 second-half M2 growth figures.

Chairman Greenspan eventually suggested following an unchanged monetary policy that called for the federal funds rate to remain between 9-3/4 and 9-7/8 percent, which corresponded to monetary policy alternative B described in the May 1989 Bluebook, with symmetric language concerning intermeeting actions. The interpretation of the economic situation was that the economy had slowed visibly but that it would stabilize without going into recession. The Chairman suggested a telephone conference call for the intermeeting period. While the vote of the FOMC on the policy directive was 11 YES and 1 NO, the discussion revealed a greater diversity of opinion. Two of the voting Reserve Bank presidents supported alternative B but wanted the symmetric language replaced with asymmetric language toward tightening. Their argument was that they did not see the slowdown of economic activity yet and that the weakness of M2 was only temporary. Two of the Governors also supported alternative B but wanted the symmetric language replaced by asymmetric language toward easing because they saw no evidence for the monetary aggregates to recover soon and also put more emphasis on the apparent risk of a slowdown of the economy. Similar arguments were put forward by the one dissenting vote.

3. The Conference Calls: May 31 and June 5, 1989

The annual growth rate of M2 in May 1989 turned out to be -3.3 percent.[3] If the Committee stood by its informal agreement to have a conference call should the money supply not recover, then this news alone was reason enough for the conference call. However, what actually triggered the call is uncertain because, unfortunately, the beginning of the May 31, 1989 call was not transcribed. References in the June 6 call to the May 31 call reveal that money growth must have been discussed at length. The FOMC was clearly troubled by the weakness of M2.

The Committee did not lower rates after the conference call on Wednesday, May 31, because it needed more time to agree on the proposed policy move (apparently, Chairman Greenspan had

[3]This number is taken from the June 30, 1989 Bluebook, but similar information must have been available at the May 31 call.

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suggested an easing but several members of the Committee were opposed). It was argued that a consensus would be easier to reach in several days, when the employment report would have shed some light on the behavior of wages and when additional money supply numbers would have become available.

The employment report released by the Labor Department on Friday, after the Wednesday call, contributed to the FOMC's assessment that inflationary pressures had abated. It showed that the civilian unemployment rate in May remained at 5.2 percent, still low relative to the perceived natural rate, which at that time was judged to be 6 percent, and also relative to historic levels. The unemployment rate had changed little over the past few months. But the employment report also revealed that payroll employment increased only by 100,000 in May, while in previous months the increase had been consistently above 200,000. Moreover, average hourly earnings in May had increased 3-3/4 percent from a year earlier, which implied a relatively flat trend in the year-to-year rise.

In the June 5 telephone call, these signals from the labor market were interpreted to mean that inflationary pressures from tightness in the labor market were much lower now than perceived at the previous FOMC meeting.

The behavior of commodity prices was also briefly mentioned in the call as another piece of evidence that inflationary pressures were easing. The June 28 Greenbook shows that several commodity price indices (the CRB futures, the Dow-Jones Spot, and the Economist) had in fact declined since the May Greenbook and also over the past year (see also Figure 5).

With inflationary pressures damped, the Committee felt that monetary policy could react to the perceived slowdown in economic activity without causing an upturn in inflation. Chairman Greenspan summarized this sentiment on the real side, "... there is a much broader softening out there than I think I perceived at the FOMC meeting..." (from May 31, 1989 call transcript).

The Committee agreed in the call on June 5 with the Chairman's proposal to lower the federal funds rate by 25 basis points. One member of the FOMC did question the policy move and would have preferred to wait longer before easing, because that member doubted whether there

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was in fact enough evidence for a slowdown in economic activity.

4. FOMC Meeting on July 5-6, 1989

At the July 1989 FOMC meeting, the staff assumed the federal funds rate would remain flat at the current level of 9-1/2 percent over the remainder of 1989. This marked a change from the previous forecasts (March and May 1989 Greenbook), which had assumed that the funds rate would rise to 10-1/2 percent by the end of the year. The reasons cited by the staff for the revision of the forecast mainly involved incoming information that evidenced a greater economic slowdown than previously perceived. The Greenbook forecast for real GNP in the 2nd quarter was revised from 3.0 percent in March to 2.3 percent in May and to 1.7 percent in June. Also, a stronger-than-anticipated appreciation of the dollar was interpreted as lowering GNP growth and, thus, reducing inflationary pressure.

> In light of these developments, the staff has lowered its assessment of the level of interest rates that will be necessary to restrain demand enough to bring inflation down. Short-term rates, rather than rising moderately over the remainder of this year, now are expected to remain around current levels, ... (p. I-4, June 28 Greenbook).

The FOMC did not follow the staff's assumption at this meeting in the sense that the intended fed funds rate was lowered 25 basis points on the day after the meeting.

5. Conclusion

Finally, it is interesting to note that the change of direction of monetary policy occurred at a time when the current and predicted future inflation rate remained high. The CPI inflation for the first quarter of 1989 was 5.4 percent, and the predicted annual CPI inflation for 1989 and 1990 was 4.9 and 4.6 percent, respectively, (see p. I-10, June Greenbook) which is higher than CPI inflation in any of the preceding seven years. The discussion of the FOMC showed that several of its members felt that this level of inflation was simply too high.

The change of direction in monetary policy also occurred at a time when the economy was perceived to be operating beyond its full employment level. The June 1989 Greenbook predicted

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the unemployment rate for the current year to be 5.4 percent, which was about .6 percentage points below the natural rate of unemployment and also at an unemployment rate which was lower than it was in any of the previous seven years.

But by the end of spring 1989, the FOMC saw a considerable slowing in activity which would damp inflationary pressures. Their judgment about future activity and prices was reinforced by substantial shortfalls in money growth.

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Table 1. FOMC Meeting February 7-8, 1989

- Domestic Policy Directive: "... In the implementation of policy for the immediate future, the Committee seeks to *maintain* the existing degree of pressure on reserve positions. Taking account ..., *somewhat* greater reserve restraint *would*, or *slightly* lesser reserve restraint *might*, be acceptable in the intermeeting period."
- Intended federal funds rate on February 7, 1989: 9%
- Intended federal funds rate at the end of the intermeeting period: 9-3/4%
- Total change over the intermeeting period: +75 basis points
- Policy actions during the intermeeting period:

Effective Date of Tightening[4] of Money Market Conditions	Change in the Intended Federal Funds Rate (in basis points)	New Intended Trading Range of the Federal Funds Rate (in percent)
February 14, 1989	+25	9-1/4 - 9-3/8
February 23, 1989	+25	9-1/2 - 9-5/8
February 24, 1989	+25	9-3/4
	Change in the Discount Rate	New Level
February 24, 1989	+50	7.00

[4]This table lists the effective dates of changes in money market conditions. It indicates the range of the federal funds rate expected to be consistent with the degree of reserve pressure desired by the FOMC. Sometimes that degree of reserve pressure was expected to be consistent with a trading range for the federal funds rate – typically 1/8 of one percent wide – and sometimes it was expected to be consistent with a point estimate for the federal funds rate. On occasion, the trading range for the federal funds rate expected to be consistent with a given level of reserve market pressure changed. This is reflected in a change in the midpoint of the intended trading range for the federal funds rate (shown in Figure 1) on a date not included in this table. That is, on occasion the midpoint of the trading range changed even though there was no change in the desired degree of reserve market pressure. These changes in the midpoint of the trading range for the federal funds rate were 6.25 basis points.

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Table 2. FOMC Meeting March 28, 1989

- Domestic Policy Directive: "... In the implementation of policy for the immediate future, the Committee seeks to *maintain* the existing degree of pressure on reserve positions. Taking account ..., *somewhat* greater reserve restraint *would*, or *slightly* lesser reserve restraint *might*, be acceptable in the intermeeting period."
- Intended federal funds rate on March 28, 1989: 9-3/4%
- Intended federal funds rate range at the end of the intermeeting period: 9-3/4 - 9-7/8 %
- No telephone conference in the intermeeting period
- No change in the discount rate in the intermeeting period
- No policy actions during the intermeeting period

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Table 3. FOMC Meeting May 16, 1989

- Domestic Policy Directive: "... In the implementation of policy for the immediate future, the Committee seeks to *maintain* the existing degree of pressure on reserve positions. Taking account ..., *somewhat* greater reserve restraint or *somewhat* lesser reserve restraint *would*, be acceptable in the intermeeting period."
- Intended federal funds rate trading range on May 16, 1989: 9-3/4 - 9-7/8%
- Intended federal funds rate trading range at the end of the intermeeting period: 9-1/2 - 9-5/8%
- Total change over the intermeeting period: -25 basis points
- Two telephone conference calls in the intermeeting period, Wednesday May 31 and Monday June 5, 1989.
- No change in the discount rate in the intermeeting period
- Policy actions during the Intermeeting Period:

Effective Date of Easing of Money Market Conditions	Change in the Intended Federal Funds Rate (in basis points)	New Intended Trading Range of the Federal Funds Rate (in percent)
June 6, 1989	- 25	9-1/2 - 9-5/8

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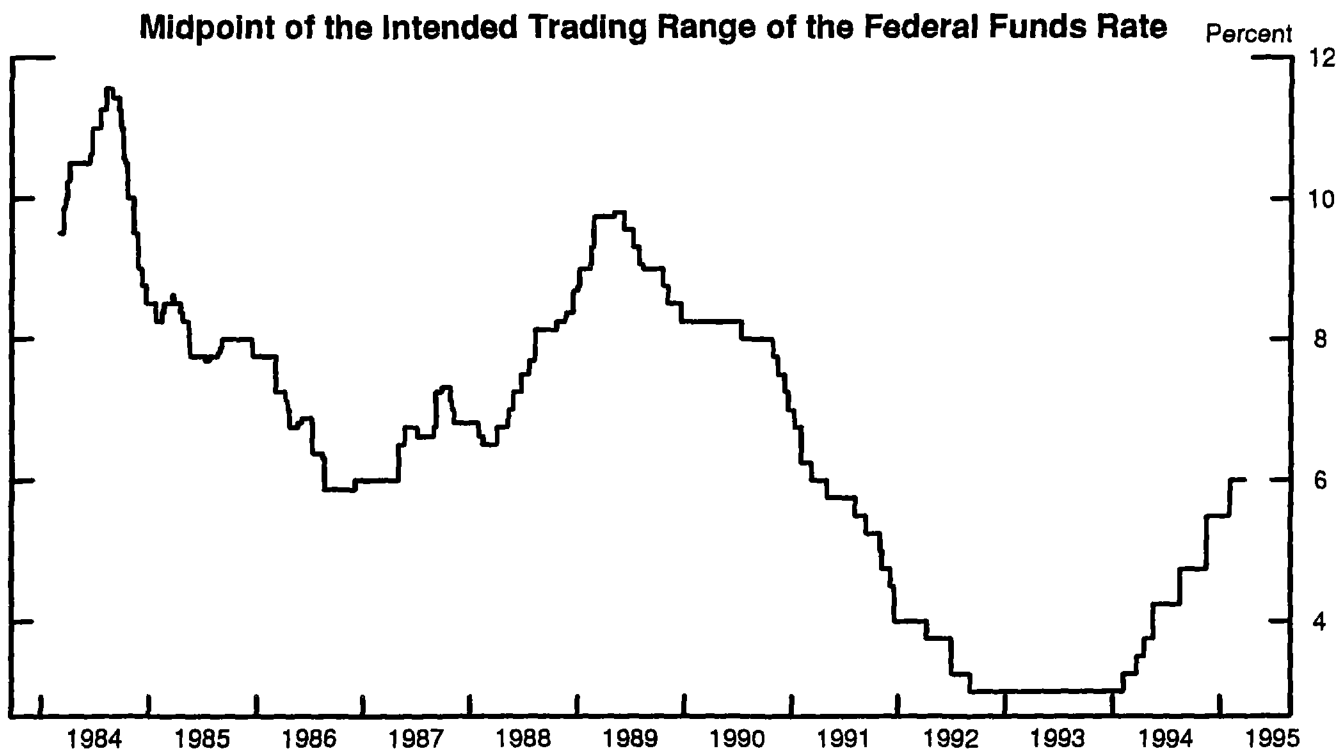
Table 4. FOMC Meeting July 5-6, 1989

- Domestic Policy Directive: '... 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 ..., *somewhat greater* reserve restraint or *somewhat lesser* reserve restraint *would*, be acceptable in the intermeeting period."
- Intended federal funds rate trading range on July 5, 1989: 9-1/2 - 9-5/8 %
- Intended federal funds rate at the end of the intermeeting period: 9%
- Total change over the intermeeting period: -50 basis points
- No change in the discount rate in the intermeeting period
- Policy actions during the intermeeting period:

Effective Date of Easing of Money Market Conditions	Change in the Intended Federal Funds Rate (in basis points)	New Intended Trading Range of the Federal Funds Rate (in percent)
July 7, 1989	- 25	9-1/4 - 9-3/8
July 27, 1989	- 25	9 - 9-1/8

Figure 1



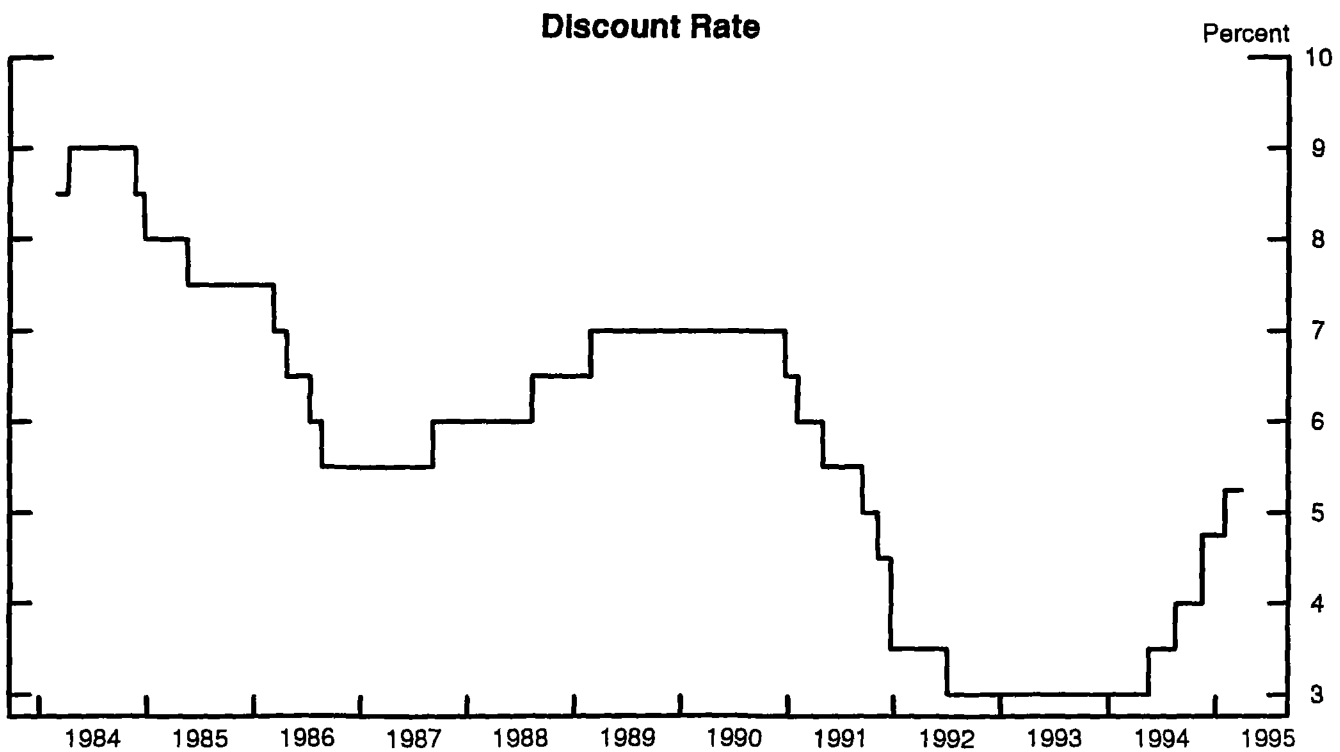


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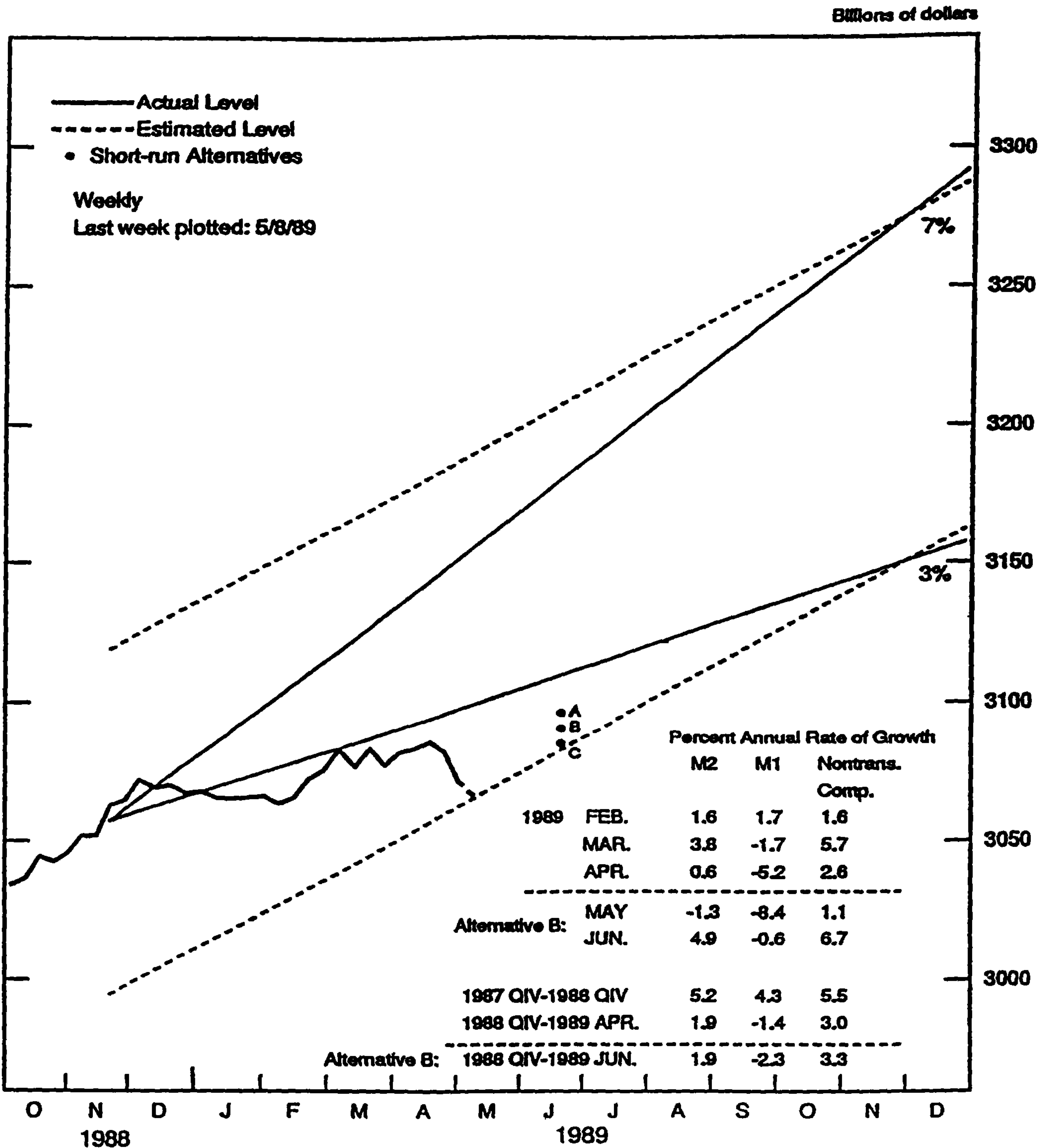
Figure 2

M2



Percent Annual Rate of Growth

		M2	M1	Nontrans. Comp.
1989	FEB.	1.6	1.7	1.6
	MAR.	3.8	-1.7	5.7
	APR.	0.6	-5.2	2.6
Alternative B:	MAY	-1.3	-8.4	1.1
	JUN.	4.9	-0.6	6.7
	1987 QIV-1988 QIV	5.2	4.3	5.5
	1988 QIV-1989 APR.	1.9	-1.4	3.0
Alternative B:	1988 QIV-1989 JUN.	1.9	-2.3	3.3

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Figure 3

Spread Between Federal Funds and 3-Month T-Bill Rates

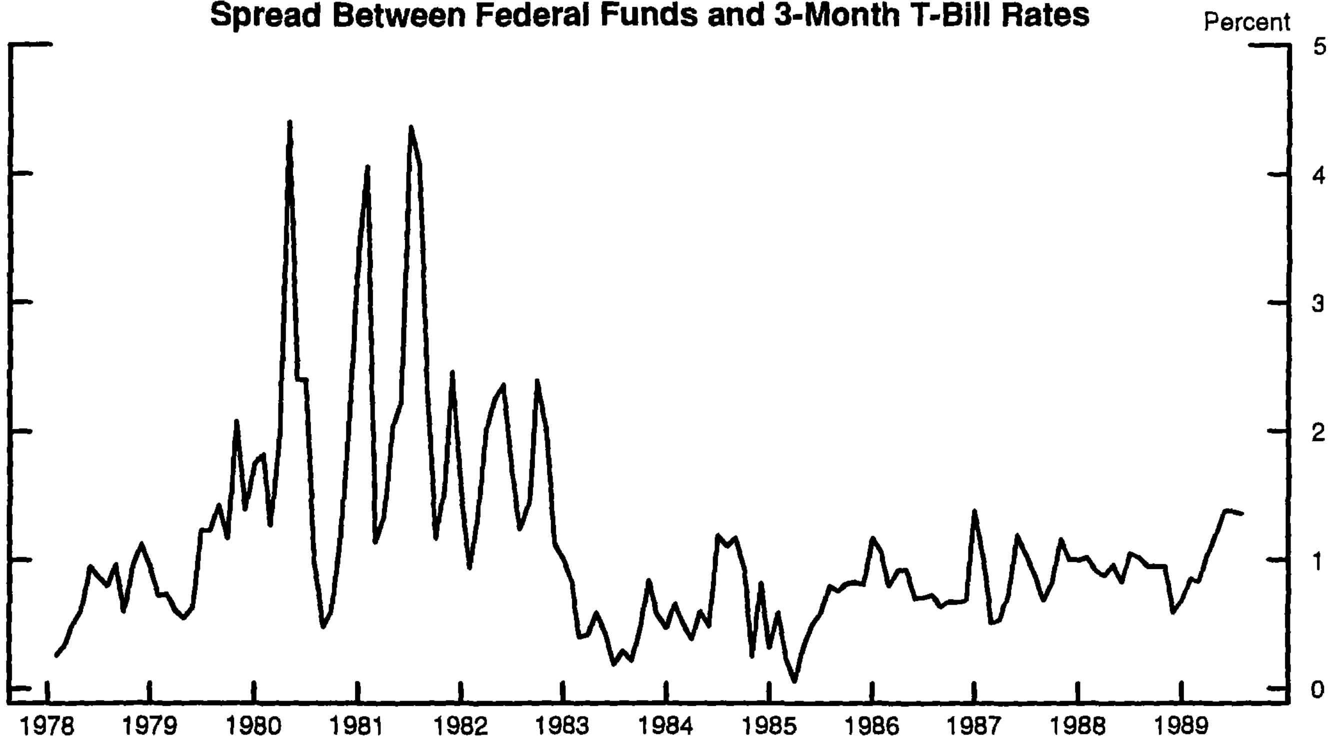

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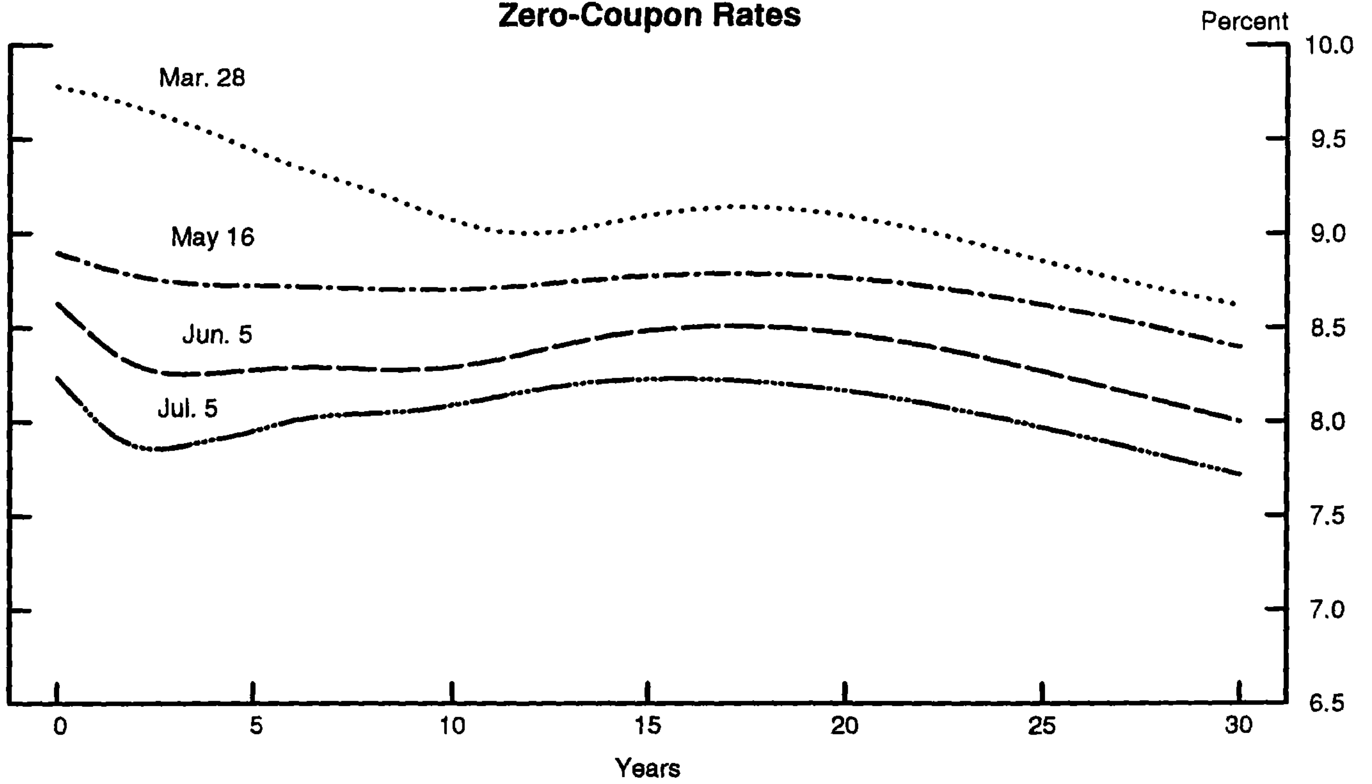
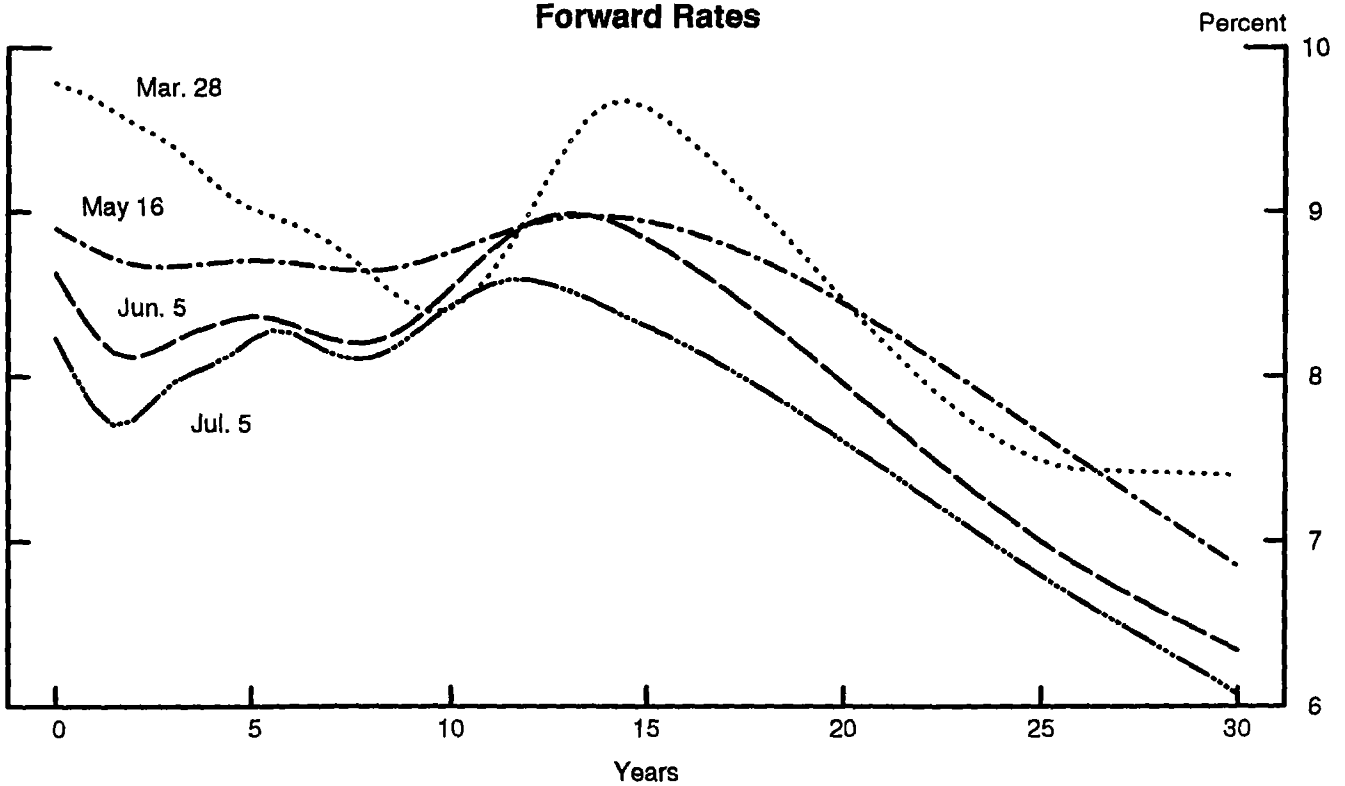
Figure 4





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