FEDERAL RESERVE press release

For Use at 4:30 p.m. February 14, 1986

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 16-17, 1985.

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 16-17, 1985

Domestic policy directive

The information reviewed at this meeting suggested that economic activity was expanding at a relatively modest pace. The underlying trend in inflation appeared to have changed little, as broad measures of prices and wages were rising at rates close to those recorded earlier in the year.

Total nonfarm payroll employment increased further in November, though less than in October, and the civilian unemployment rate edged down to 7.0 percent. Over the two-month period employment gains averaged 270,000, about equal to the average monthly increase in the third quarter. Most of the growth in employment continued to be in service industries and at finance and trade establishments. But manufacturing employment, after contracting during the first three quarters of the year, rose substantially in October and moved up further in November. Moreover, the length of the factory workweek remained at a relatively high level.

The index of industrial production rose an estimated 0.4 percent in November, reversing the drop in October. Output of defense and space equipment continued at a brisk pace over the two-month period. For most other broad categories of products and equipment, gains in November roughly retraced the declines posted in October.

Total retail sales rose in November and gains were recorded at most major types of stores, with particularly large increases registered at general merchandise outlets. But sales had dropped sharply in October --

attributable largely to a reduction of more than 17 percent in sales at automotive outlets that was associated with the ending of financing and price concessions on 1985 automobiles -- and the November increase only partially offset that decline. For the two-month period sales were 1 percent below the average for the third quarter. Sales of domestic automobiles remained relatively sluggish in November, and manufacturers reintroduced some limited financing incentives. In early December domestic auto sales picked up to an annual rate of nearly 7-1/2 million units, about 1 million units above the sales pace in October and November but still below recent and planned production levels.

In November, total private housing starts fell substantially, more than reversing the appreciable gain in the previous month. An especially sharp drop in starts of single-family homes accounted for most of the decline. Over the two-month period total starts were at an average annual rate of 1.65 million units, about the same as in the third quarter. Newly issued permits for residential construction averaged somewhat below the rate recorded for the third quarter. Sales of existing homes picked up in October (the latest month for which data were available) from their third-quarter pace, but sales of new homes dropped. Interest rates at S&Ls on new commitments for fixed-rate conventional home mortgage loans had stabilized in the 12-1/8 to 12-1/4 percent range from August through most of October, but declined considerably in recent weeks: the average contract rate fell from about 12 percent in early November to a bit above 11-1/4 percent by mid-December.

Incoming information generally suggested sluggishness in business capital spending. In October shipments of nondefense capital goods picked up after changing little in the third quarter, but new orders for such goods fell appreciably. Outlays for nonresidential construction have been essentially flat over recent months. Moreover, recent surveys of business capital spending plans suggested little real growth in that sector for next year.

Recent monthly data on prices have shown higher rates of increase than those recorded in the spring and summer, reflecting what was expected to be a temporary spurt in prices of food and energy-related items. The producer price index for finished goods rose 0.9 and 0.8 percent in October and November respectively, after falling in three of the preceding four months. Thus far in 1985, the index had increased at an annual rate of about 1-1/2 percent, slightly below the rate in 1984. The consumer price index rose 0.3 percent in October, slightly above the 0.2 percent monthly increase recorded from May through September. Over the first 10 months of the year, consumer prices increased at an annual rate of about 3-1/4 percent, compared with a rise of 4 percent in 1984. The rate of increase in the index of average hourly earnings through November of this year remained close to the 3 percent pace posted over the course of 1984.

The trade-weighted value of the dollar against major foreign currencies had declined about 2-1/2 percent on balance since the Committee's meeting on November 4-5, though in recent weeks the dollar's value had tended to stabilize. Revised data on merchandise trade for the third quarter confirmed that the deficit had widened further, to an estimated annual rate of $133 billion, as non-oil imports rose and exports fell somewhat.

At its meeting on November 4-5, 1985, the Committee had adopted a directive that called for maintaining generally the existing degree of pressure on reserve positions. That action was expected to be consistent with growth of both M2 and M3 at an annual rate of about 6 percent for the period from September to December. Over the same period, M1 also was expected to expand at an annual rate of around 6 percent, but in light of its very rapid growth in the third quarter, the members indicated that slower growth in that aggregate would be acceptable. The members agreed that somewhat greater reserve restraint might, and somewhat lesser restraint would, be acceptable depending on the behavior of the monetary aggregates over the intermeeting period and taking account of appraisals of the strength of the business expansion, the performance of the dollar on foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. It was understood that policy might be implemented with somewhat more flexibility than usual, given the sensitivity of economic and financial conditions and exchange market developments. The intermeeting range for the federal funds rate was retained at 6 to 10 percent.

After declining slightly in October, M1 expanded at an annual rate of about 13 percent in November. Growth in M2 and M3 continued quite moderate in November, at annual rates of about 6-1/2 and 5 percent respectively. Through November, M1 expanded at a pace well above the range set by the Committee in July of 3 to 8 percent at an annual rate over the period from the second quarter to the fourth quarter of the year; M2 grew at a rate a bit below the upper limit of its range of 6 to 9 percent for the year and M3 expanded at a rate near the midpoint of its range of 6 to 9-1/2 percent for 1985. Expansion in total domestic nonfinancial debt apparently was quite rapid in November, and growth in that aggregate remained somewhat above the upper end of its 9 to 12 percent monitoring range for the year.

Given expansion in the broader monetary aggregates at a pace close to the Committee's expectations for the September-to-December period and within their longer-run ranges as well, and with account taken of economic and financial developments, open market operations during the intermeeting interval were directed toward maintaining approximately unchanged conditions of reserve availability. Reserve management was complicated by the concentrated settlement of large Treasury security issues delayed by debt ceiling problems and by a computer breakdown at a major bank that led to an overnight loan from the Federal Reserve discount window in excess of $22 billion -- an unprecedented amount. Excluding that borrowing, seasonal plus adjustment credit from the discount window averaged around $725 million during the two complete reserve maintenance periods after the Committee's meeting in early November. During that period, excess reserves were unusually large, affected for a time by a maldistribution of reserves in the wake of the $22 billion borrowing. Thus far in the current maintenance period, borrowing was running about $175 million.

The federal funds rate averaged around 8 percent during the intermeeting period, but exhibited considerable day-to-day and week-to-week volatility associated with the extraordinary level of borrowing noted above and pressures related to the need to finance a very large volume of Treasury issues. Rates on Treasury bills generally fell about 20 to 35 basis points over the intermeeting interval, while other short-term rates typically moved down about 10 to 15 basis points. Long-term interest rates dropped appreciably further over the period, falling about 1/2 to 3/4 percentage point.

In the Committee's discussion of the economic situation and outlook, individual members expressed somewhat differing views regarding prospects for economic growth in 1986. The staff projections presented at this meeting had suggested that growth in real GNP would continue at a relatively modest pace in 1986, with the average unemployment rate and the rate of increase in prices during the coming year expected to change little from the rates in 1985. While the staff projection was seen as a plausible assessment of the outlook, several members emphasized that any current forecast was subject to a great deal of uncertainty. They referred, for example, to the difficulty of evaluating the potential impact of deficit reduction and tax reform legislation, and to the uncertainties surrounding the outlook for the U.S. trade balance. Some members concluded that the economy might prove to be somewhat stronger than the staff was projecting, but several stressed the possibility of appreciably slower growth. In this connection, one member cautioned that a sluggish expansion would be vulnerable to an actual downturn in the event of adverse developments in particular sectors of the economy.

In the course of the discussion, some members commented that a sector-by-sector review of the economy tended to suggest a relatively weak expansion in 1986, and one clearly subject to downside risks, but several members also cited a number of broad factors that they felt would tend to sustain overall economic growth. These factors included the appreciable fall in longer-term interest rates, including mortgage rates, and the rise in stock market prices over the course of recent weeks, the decline in the foreign exchange value of the dollar, and the substantial growth in money. On the negative side, members referred to the rapid rise in debt burdens, the exposure of financial institutions to domestic and international debt problems, and the difficulties in some sectors of the economy. Also mentioned was the possibility that as legislation to reduce future federal deficits became effective it would tend to exert a dampening influence on economic activity, although such legislation was urgently needed to foster the longer-run health of financial markets and the economy.

Turning to particular sectors of the economy, the members again underscored the variation in conditions among industries and their uneven contribution to current and prospective economic activity. Moderate growth was considered to be a reasonable expectation for many sectors of the economy. At the same time, the members expressed concern about the persisting problems and financial strains in some industries such as agriculture and a number of manufacturing and extractive businesses, notably those that competed actively with foreign producers. In agriculture, prices remained generally depressed despite recent increases in some crop and especially in livestock prices, and many producers and lenders continued under severe financial pressure. Reference was also made to the loss of momentum in investment spending, associated in part with the aging of the business expansion but also reflecting uncertainties about still pending tax reform legislation. Consumer spending was thought likely to expand further, but its growth would probably be inhibited by the buildup in consumer debt that had already taken place. In the housing market, starts had been lower than many expected, given the reductions in mortgage interest rates.

The reduced value of the dollar could be expected to foster some improvement in the trade balance over time, with favorable implications for domestic economic activity, though with the potential for adding to upward price pressures. Export demand might also be enhanced by somewhat faster growth in some major European economies. Some members suggested, however, that the prospective improvement in the trade balance might be restrained in the event of foreign retaliation to any new protectionist measures adopted by the United States. The dollar had tended to stabilize in recent weeks, but members remained concerned that a renewed decline, particularly if it should be precipitate, would have disruptive repercussions.

With regard to the outlook for inflation, the members saw little reason at this time to expect significant changes from the rates of increase experienced in 1985. The reduced value of the dollar in foreign exchange markets would tend to exert some upward pressure on prices, but continued softness in world commodity prices, especially oil, could have offsetting effects. Inflationary sentiment appeared to have diminished, as evidenced by the recent performance of the stock and bond markets, and with continuing competition from abroad, price competition could be expected to remain intense in many markets. Moreover, the general pattern of labor settlements so far did not suggest any substantial acceleration of cost pressures during the year ahead.

At its meeting in July the Committee had agreed on tentative growth ranges of 4 to 7 percent for M1 and 6 to 9 percent for both M2 and M3 for the period from the fourth quarter of 1985 to the fourth quarter of 1986. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for 1986. At this meeting the Committee reviewed background technical factors bearing on the ranges for 1986, including the implications of the final phase of deposit deregulation early in the year. It was anticipated that at its next meeting the Committee would reassess the tentative ranges and establish definite ranges as required by the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act).

In the Committee's discussion of policy implementation for the period ahead, the members differed to some extent in their views concerning an appropriate degree of pressure on reserve positions. Some favored directing open market operations, at least initially, toward maintaining approximately unchanged conditions of reserve availability. A majority, however, indicated a preference for moving toward implementing some slight easing of reserve conditions. Several also commented that decisions about the precise degree of reserve pressure should depend in part on whether the discount rate was reduced, and if so by how much.

Members who leaned toward maintaining prevailing reserve conditions expressed particular concern about the rate of growth in money and credit and the inflationary implications of further rapid growth. They agreed that the outlook for economic expansion remained uncertain, but in their view business activity was likely to be satisfactory, given current reserve conditions, especially in view of recent developments in financial markets, the lower dollar, and the buildup in money and liquidity. Other members, while recognizing the risks of unduly rapid monetary growth, were more concerned that the rate of economic expansion might remain inadequate. In that context, some thought that the recent declines in longer-term interest rates, which would help sustain the economy, were premised to an extent on expectations of an easier monetary policy. One member commented that real interest rates were still relatively high in any event and were exerting a restraining influence on economic activity. It was also noted that reduced interest rates would lessen, though by no means eliminate, the financial strains in some sectors of the economy and the external debt problems of several developing countries.

The members agreed that the extent of any easing was constrained by a number of considerations, including the need to avoid unduly rapid expansion in money and credit and the potential vulnerability of the dollar to a relative decline in U.S. interest rates. It was also suggested that a sharp move toward ease under present circumstances might well foster a resurgence of inflationary expectations, with adverse repercussions over time on financial markets and the sustainability of the economic expansion.

According to an analysis prepared for this meeting, the degree of pressures on reserve positions being considered by the members was likely to be associated with some slowing in M1 growth during the early months of 1986, while the broader aggregates might continue to expand at moderate rates. While the final phase of deposit deregulation was expected to have little net impact on monetary growth during the first quarter, the members recognized that the relationship between money and GNP remained subject to a great deal of uncertainty. They noted that the demand for M1 had deviated considerably from historical experience and that it was very difficult to predict when the unusual weakness in M1 velocity, which had been evident for several quarters, would be reversed and a more normal pattern would emerge. In the circumstances, some sentiment was expressed for further reducing the emphasis on M1, but a majority of the members agreed that it should be retained as one guide among others for the conduct of monetary policy.

In keeping with past practice, the members considered the question of possible intermeeting adjustments in the degree of pressure on reserve positions. While no member wanted to rule out possible adjustments in either direction, most believed that policy implementation should be especially alert to the potential need for some further easing in light of the relatively sluggish performance of the economy and the generally favorable outlook for prices and wages. Policy implementation also needed to take account of the behavior of the monetary aggregates, conditions in domestic and international financial markets, and developments in foreign exchange markets, as well as the impact of a reduction in the discount rate, should one take place. It was also suggested that the Committee's expectations with regard to the short-run growth of the aggregates be stated with less precision than in the past and that the behavior of M1, in particular, be evaluated in the context of other economic and financial developments, including the growth of the broader aggregates. In one view, however, any substantial deviation of M1 growth from expectations should be resisted -- in either direction -- by an appropriate adjustment in the degree of reserve pressure.

At the conclusion of the Committee's discussion, most of the members indicated that they favored or could accept a directive that called for some limited decrease in the degree of pressure on reserve positions. The members expected such an approach to policy implementation to be consistent with growth of M2 and M3 at annual rates of 6 to 8 percent for the four-month period from

November to March. Over the same period they expected the expansion of M1 to slow to an annual rate of 7 to 9 percent, though the outlook for M1 growth continued to be subject to unusual uncertainty. Somewhat greater reserve restraint might, and somewhat lesser restraint would, be acceptable over the intermeeting period depending on the growth of the monetary aggregates, the strength of the business expansion, the performance of the dollar on foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The members agreed that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 6 to 10 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 is expanding at a relatively modest pace in the current quarter. Total nonfarm payroll employment increased further in November, though less than in October, and the civilian unemployment rate edged down to 7.0 percent. Retail sales and industrial production picked up in November after declining in October. After strengthening in October, housing starts fell appreciably in November. Incoming information generally suggests relatively sluggish business capital spending. Revised merchandise trade data for the third quarter confirm that the deficit widened further, as non-oil imports continued to increase and exports fell somewhat. Broad measures of prices and wages appear to be rising at rates close to those recorded earlier in the year.
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> After declining in October, M1 grew substantially in November while growth in M2 and M3 continued quite moderate. Expansion in total domestic nonfinancial debt has remained rapid. Through November, M1 expanded at a rate well above the long-run range set by the Committee,

M2 grew at a rate a bit below the upper end of its range for the year, and M3 expanded at a rate near the mid-point of its range for 1985. Treasury bill rates have fallen somewhat while other short-term market interest rates have changed little on balance since the November meeting of the Committee; long-term rates have moved appreciably lower over the period. The trade-weighted value of the dollar against major foreign currencies has declined on balance since the Committee's meeting in early November, though the dollar has tended to stabilize more recently.

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation further, 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 the July meeting reaffirmed ranges for the year of 6 to 9 percent for M2 and 6 to 9-1/2 percent for M3. The associated range for total domestic nonfinancial debt was reaffirmed at 9 to 12 percent. With respect to M1, the base was moved forward to the second quarter of 1985 and a range was established at an annual growth rate of 3 to 8 percent. The range takes account of expectations of a return of velocity growth toward more usual patterns, following the sharp decline in velocity during the first half of the year, while also recognizing a higher degree of uncertainty regarding that behavior. The appropriateness of the new range will continue to be reexamined in the light of evidence with respect to economic and financial developments including developments in foreign exchange markets. More generally, the Committee agreed that growth in the aggregates may be in the upper parts of their ranges, depending on continuing developments with respect to velocity and provided that inflationary pressures remain subdued.

For 1986 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1985 to the fourth quarter of 1986, of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9 percent for M3. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1986. With respect to M1 particularly, the Committee recognized that uncertainties surrounding recent behavior of velocity would require careful reappraisal of the target range at the beginning of 1986. Moreover, in establishing ranges for next year, the Committee also recognized that account would need to be taken of experience with institutional and depository behavior in response to the completion of deposit rate deregulation early in the year.

In the implementation of policy for the immediate future, the Committee seeks to decrease somewhat the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2 and M3 over the period from November to March at annual rates of about 6 to 8 percent; while the behavior of M1 continues to be subject to unusual uncertainty, growth at an annual rate of 7 to 9 percent over the period is anticipated. Somewhat greater reserve restraint might, and somewhat lesser reserve restraint would, be acceptable depending on behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent.

Votes for this action: Messrs. Volcker, Corrigan, Forrestal, Guffey, Keehn, Martin, Partee, Rice, and Ms. Seger. Vote against this action: Mr. Black. Absent and not voting: Messrs. Balles and Wallich. (Mr. Guffey voted as alternate for Mr. Balles.)

Mr. Black dissented because he was concerned about the rapid growth of M1 and he did not think a decrease in the degree of pressure on reserve positions was desirable under present circumstances.