FEDERAL RESERVE press release

For Use at 4:30 p.m. February 10, 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 December 13-14, 1988.

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 13-14, 1988

Domestic Policy Directive.

Information on employment and production reviewed at this meeting suggested that, apart from the direct effects of the drought, economic activity had continued to expand at a vigorous pace although some measures of demand, available on a less current basis, still indicated more moderate growth. Recent price data showed a fairly stable inflation rate, partly because of the favorable effects of earlier oil price declines, while labor cost measures continued to indicate some acceleration from a year earlier.

Total nonfarm payroll employment rose sharply in October and November. Following declines in late summer, gains in manufacturing employment were large in both months, with particularly sizable increases recorded in the machinery, electrical equipment, and lumber industries. Employment in service industries picked up significantly in November from the reduced pace of expansion in previous months. The civilian unemployment rate edged up to 5.4 percent in November but remained in the lower part of the narrow range that had prevailed since early spring.

Industrial production advanced considerably further in October and November after a strong third quarter. Output of consumer goods continued to increase, on balance, at a fairly vigorous pace, and production of materials posted another solid gain in November. Output

of business equipment also increased in November, but revised data indicated that such growth had moderated appreciably in recent months. Total industrial capacity utilization edged up further in November, and the operating rate in manufacturing reached its highest level since July 1979.

Growth of overall consumer spending had moderated somewhat in recent months. Spending for nondurables had been sluggish in September and October while outlays for durable goods had declined, mainly because of reduced purchases of cars. On the other hand, preliminary data for total retail sales in November indicated a strong advance following a large, upward-revised increase in October.

Indicators of business capital spending suggested a substantially slower rate of expansion in October than earlier in the year. Shipments of nondefense capital goods were little changed, reflecting a fairly broad-based deceleration. Nonresidential construction edged down a little further, as petroleum drilling fell again and expenditures on commercial structures other than office buildings declined. Inventory investment in the manufacturing and wholesale sectors in the third quarter remained about in line with the growth of sales. In the retail sector, a buildup in inventories in the third quarter largely reflected additions to stocks by auto dealers; the expansion of nonauto stocks remained broadly in line with sales. Housing starts strengthened in October after changing little on balance over the previous several months.

Excluding food and energy, producer prices of finished goods were unchanged in October after a sizable increase in September. At the

consumer level, retail food prices eased in October and energy prices were little changed, but prices of other goods and services increased faster on balance than in preceding months. On a year-over-year basis, consumer prices continued to rise at about the 4-1/2 percent annual rate evident since late 1987. The limited data available for labor costs in the fourth quarter suggested that increases in these costs continued to exceed those of a year earlier.

Preliminary data for the nominal U.S. merchandise trade deficit in October showed a slightly smaller deficit than in September. The value of total imports fell, with declines recorded in capital goods, consumer goods, and oil. Exports also declined in October owing to lower agricultural sales abroad. Boosted by higher aircraft shipments, nonagricultural exports were unchanged from their September level. Economic activity accelerated or remained strong in most of the major foreign industrial countries in the third quarter but appeared to have slowed somewhat in the fourth quarter.

In the foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies had declined about 2-1/2 percent on balance over the period since the Committee meeting on November 1, bringing it to a level 8 percent below its peak of last August. Following a brief respite in the week before the U.S. elections, the dollar was under downward pressure over most of the intermeeting period. However, the dollar firmed somewhat near the end of the period, as prospects were seen to be increasing for further reductions in the federal deficit and a tightening of monetary policy.

At its meeting on November 1, the Committee adopted a directive calling for no immediate change in the degree of pressure on reserve positions. These reserve conditions were expected to be consistent with growth of M2 and M3 at annual rates of about 2-1/2 and 6 percent respectively over the period from September to December. The members agreed that somewhat greater reserve restraint would, or slightly lesser reserve restraint might, be acceptable depending on indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets.

In the course of implementing policy following the November meeting, it became increasingly evident that a slightly higher federal funds rate than that anticipated at the time of the meeting was associated with a substantially lower volume of adjustment plus seasonal borrowing; for reasons that remained unclear, depository institutions exhibited a reduced willingness to come to the discount window. To take account of this change in borrowing behavior, and against a backdrop of recent information suggesting that the economic expansion retained considerable vigor and potential for price pressures, the Manager for Domestic Operations adjusted the reserve paths on November 22 to incorporate a lower level of borrowings, with the expectation that federal funds would continue trading in the slightly higher range that had prevailed recently. Over the intermeeting period, the federal funds rate rose nearly 1/4 percentage point to around 8-1/2 percent.

Other short-term market interest rates generally advanced by more than the federal funds rate over the intermeeting period, as expectations of a tighter monetary policy were stimulated by higher world oil prices, renewed weakness of the dollar, and the release of strong domestic economic data. The prime rate was increased 50 basis points. Rates in long-term debt markets also rose on balance, although by appreciably less than short-term rates. Stock prices fell over the first half of the intermeeting period, but most indexes rebounded subsequently to nearly their values at the time of the November 1 meeting.

Growth of the broader monetary aggregates strengthened in November from the relatively sluggish rates of expansion recorded in previous months, especially for M2. The acceleration in M2 reflected strong expansion in its liquid retail components. M3 growth picked up somewhat less, as bank credit growth and associated funding needs remained moderate. On average in October and November, growth of M2 had been somewhat faster, and that of M3 slightly faster, than the Committee expected at the time of the previous meeting. With demand deposits running off again, M1, which had increased only slightly on balance since midsummer, was virtually unchanged in November.

The staff projection prepared for this meeting suggested that, after adjustment for the effects of the drought, economic growth in the current quarter might be near the vigorous pace of the third quarter but that expansion in 1989 was likely to moderate on balance. However, to the extent that expansion of final demand at a pace that could foster higher inflation was not accommodated by monetary policy, pressures would be generated in financial markets that would tend to restrain

domestic spending. The staff continued to project some slowing in the growth of consumer spending, sharply reduced expansion of business fixed investment, and sluggish housing activity. Foreign trade was expected to make an important contribution to growth in domestic output, despite some damping effects from the dollar appreciation that had occurred earlier in 1988 and somewhat slower growth abroad. The staff also anticipated some continuing cost pressures over the next several quarters, especially owing to reduced margins of unutilized labor and other production resources.

In the Committee's discussion of the economic situation and outlook, the members focused on indications of continuing strength in the economic expansion. While some signs of prospective slowing in the expansion remained in evidence, recent data on employment and production suggested that the economy retained considerable momentum. A number of members commented that business activity had remained more robust than had seemed likely earlier, and many expressed concern that continued expansion at a relatively rapid pace raised the risk that inflation would intensify, given already high rates of capacity utilization in many industries and tight labor markets in many parts of the country. On balance, while somewhat more moderate growth continued to be viewed as a reasonable expectation for 1989, most members interpreted recent developments as suggesting that, in the absence of some added policy restraint, any moderation in the expansion might well prove to be insufficient to forestall a pickup in inflation, much less to permit progress to be made in reducing inflation over time. At the same time, some members cautioned that the risk of a recession stemming from a

substantial tightening of policy should not be overlooked; in addition to job and output losses, a recession could impede progress in bringing the federal budget into balance and could have severe repercussions on the viability of highly leveraged borrowers and many depository institutions.

In their review of developments bearing on the economic outlook, members took account of indications that overall domestic demands were being well maintained, including some recent strength in retail sales, and that exports remained on a clear uptrend. High levels of activity continued to characterize business conditions in many areas. Manufacturing was benefiting from growing export markets and the substitution of domestic products for higher-priced imports; moreover, many domestic producers had not yet exploited potential markets abroad. There were indications of some softening in business fixed investment, including a moderation of growth in outlays for equipment and reduced construction activity in a number of areas, notably those most affected by weak energy markets and previous overbuilding. Nonetheless, business contacts suggested that overall investment spending would continue to benefit from ongoing efforts in many industries to modernize or expand production facilities. With regard to housing construction, members reported somewhat depressed conditions in a number of areas, but the latest statistics for the nation as a whole were on the firm side of recent trends.

In the course of the Committee's discussion, members gave a good deal of attention to the outlook for inflation. On the positive side, inflationary expectations did not appear to be worsening, as

evidenced for example by the stability of long-term bond markets, and strong competitive pressures were encouraging business firms to persist in their efforts to hold down costs. Such competition continued to make it difficult for many businesses to pass on increasing costs through higher prices and tended to harden business resistance to demands for higher wages. With regard to labor costs, reports from local areas suggested that non-wage components were rising at a faster rate than wages but that large increases in the latter still were infrequent despite some shortages of labor.

While the members saw no clear evidence in current aggregate measures of prices that the overall rate of inflation was worsening, key indicators of labor compensation suggested some uptrend and many members commented that the risks were in the direction of greater inflation, given the apparent growth of the economy at a pace above its long-run potential together with the relatively full employment of production resources. These risks would be heightened if the dollar were to decline significantly from current levels. Commodity prices appeared to have leveled off, but they showed little sign of reversing earlier increases which themselves might not yet have been passed through fully to consumer prices. Of particular concern was the prospect that, in the absence of a timely move to restraint, greater inflation would become embedded in the economy, especially in the labor-cost structure. A new wage-price spiral would then be very difficult to avoid and the critical task of bringing inflation under control would be prolonged and much more disruptive. A worsening of inflationary pressures and inflation expectations, if unchecked, eventually would foster higher interest

rates and would lead to growing imbalances and distortions in the economy and almost certainly to a downturn at some point in overall economic activity.

At its meeting in late June, the Committee reviewed its basic policy objectives for growth of the monetary and debt aggregates in 1988 and established tentative objectives for expansion of those aggregates in 1989. For the period from the fourth quarter of 1987 to the fourth quarter of 1988, the Committee reaffirmed the ranges of 4 to 8 percent that it had set in February for growth of both M2 and M3. The monitoring range for expansion of total domestic nonfinancial debt in 1988 was left unchanged from its February specification of 7 to 11 percent. For the year through November, M2 grew at an annual rate a little below, and M3 at a rate a little above, the midpoint of their annual ranges. Expansion of total domestic nonfinancial debt appeared to have moderated to a pace somewhat below the midpoint of its range. For 1989 the Committee agreed in June on tentative reductions to ranges of 3 to 7 percent for M2 and 3-1/2 to 7-1/2 percent for M3. The monitoring range for growth of total domestic nonfinancial debt was lowered to 6-1/2 to 10-1/2 percent for 1989. It was understood that all the ranges for next year were provisional and that they would be reviewed in February 1989 in the light of intervening developments. With respect to M1, the Committee reaffirmed in June its earlier decision not to set a specific target for growth in 1988 and it also decided not to establish a tentative range for 1989.

In the Committee's discussion of policy for the near term, nearly all the members supported a proposal that called for an immediate

increase in the degree of reserve pressure to be followed by some further tightening at the start of 1989 unless incoming evidence on the behavior of prices, the performance of the economy, or conditions in financial markets differed greatly from current expectations. The appropriate degree of reserve restraint also would be reevaluated in the event of an increase in the discount rate. While the members recognized that the degree of monetary restraint could be overdone, they generally felt the risks of a downturn stemming from the limited tightening under consideration were extremely small and needed to be accepted in light of what they perceived as the much greater threat of a recession if inflation were allowed to intensify. Expressing a differing view, one member commented that further restraint was undesirable in light of that member's expectation that economic growth over the next several quarters was likely to be at a pace consistent with progress against inflation.

While all but one member agreed on the need for some further monetary restraint, views differed to some extent with regard to the appropriate degree and timing of such restraint. A number of members indicated a preference for a stronger immediate move to greater restraint, given their perception of the urgency of countering inflation expectations and inflationary pressures in the economy. Other members did not disagree that inflation was a serious problem, but they preferred a more gradual approach to further restraint in order to minimize potential market disturbances, especially around the year-end, and to facilitate adjustments to rising interest rates. It also was suggested that more marked tightening at this time could have the unintended effect of fostering an escalation of interest rates in world markets,

with especially undesirable effects on many less developed debtor nations.

In the discussion of adjustments in the provision of reserves through open market operations, many members commented on how a possible increase in the discount rate might interact with such operations. Several favored the implementation of a tighter policy through the discount rate in order to signal more clearly than through a gradual tightening of reserve conditions the System's ongoing commitment to an anti-inflationary policy. Other members expressed concern that, under immediately prevailing circumstances, an increase in the discount rate might have exaggerated repercussions on domestic and international financial markets. The Committee concluded that in the event of an increase in the discount rate during the intermeeting period the members would need to consult regarding the implications for the conduct of open market operations.

In the course of the Committee's discussion, the members took account of a staff analysis which suggested that monetary growth was likely to remain relatively restrained in the months immediately ahead, especially if reserve conditions were tightened. An increase in the degree of reserve restraint in line with that contemplated by the Committee would reduce growth of M2 somewhat from its recent pace, assuming a typically delayed adjustment in deposit rates to rising short-term market interest rates, while growth of M3 would continue at a somewhat higher rate than that of M2. Several members observed that restrained monetary growth would continue to be desirable, and some expressed concern that in the absence of some tightening of reserve

conditions such growth might accelerate, with inflationary implications under foreseeable economic conditions. On the other hand, in light of the limited growth in the monetary base and reserves in the past several months, some other members cautioned that sharp additional restraint on reserve provision could have an undesirably restraining effect on monetary growth and the economy.

With regard to the proposed move toward further monetary restraint shortly after the year-end, it was understood that such firming would be implemented unless emerging economic and financial conditions were to differ markedly from current expectations. Should unanticipated developments of that kind occur or should the Board of Governors approve an increase in the discount rate during the intermeeting period, the Chairman would call for a special consultation of the Committee. On the question of any additional adjustment in policy, the members generally agreed that policy implementation should remain especially alert to incoming information that might call for further firming beyond that already contemplated. In light of the tightening of reserve conditions after today's meeting and the presumption that some further monetary restraint would be implemented later during the intermeeting period, the members decided to raise the intermeeting range for the federal funds rate by one percentage point to 7 to 11 percent. With such an increase, federal funds would be expected to trade at rates averaging closer to the middle of the range. That range provides one mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded.

At the conclusion of the Committee's discussion, all but one of the members indicated that they favored or could accept a directive that called for some immediate firming of reserve conditions, with some further tightening to be implemented at the start of 1989, assuming that economic and financial conditions remained reasonably consistent with current expectations. 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 based 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. Depending on such developments, some added reserve restraint would be acceptable, or some slight lessening of reserve pressure might be acceptable. The reserve conditions contemplated at this meeting were expected to be consistent with growth of M2 and M3 at annual rates of around 3 percent and 6-1/2 percent respectively over the four-month period from November 1988 to March 1989.

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, apart from the direct effects of the drought, economic activity has continued to expand at a vigorous pace. Total nonfarm payroll employment rose sharply in October and November, with sizable increases indicated in manufacturing after declines in late summer. The civilian unemployment rate, at 5.4 percent in November, remained in the lower part of the range that has prevailed since early spring. Industrial production advanced considerably in October and November. Housing starts turned up in October after changing little on balance over the previous several months. Growth in consumer spending has been somewhat more moderate in recent months, and indicators of business capital spending suggest a substantially slower rate of expansion than earlier in the year. The nominal U.S. merchandise trade deficit narrowed further in the third quarter.

Preliminary data for October indicate a small decline from the revised deficit for September. The latest information on prices and wages suggests little if any change from recent trends.

Interest rates have risen since the Committee meeting on November 1, with appreciable increases occurring in short-term markets. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined significantly further on balance over the intermeeting period.

Expansion of M2 and M3 strengthened in November from relatively slow rates of growth in previous months, especially in the case of M2. Thus far this year, M2 has grown at a rate a little below, and M3 at a rate a little above, the midpoint of the ranges established by the Committee for 1988. M1 has increased only slightly on balance over the past several months, bringing growth so far this year to 4 percent. Expansion of total domestic nonfinancial debt for the year thus far appears to be at a pace somewhat below that in 1987 and around the midpoint of the Committee's monitoring range for 1988.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability over time, 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 late June reaffirmed the ranges it had established in February for growth of 4 to 8 percent for both M2 and M3, measured from the fourth quarter of 1987 to the fourth quarter of 1988. The monitoring range for growth of total domestic nonfinancial debt was also maintained at 7 to 11 percent for the year.

For 1989, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1988 to the fourth quarter of 1989, of 3 to 7 percent for M2 and 3-1/2 to 7-1/2 percent for M3. The Committee set the associated monitoring range for growth of total domestic nonfinancial debt at 6-1/2 to 10-1/2 percent. It was understood that all these ranges were provisional and that they would be reviewed in early 1989 in the light of intervening developments.

With respect to M1, the Committee reaffirmed its decision in February not to establish a specific target for 1988 and also decided not to set a tentative range for 1989. The behavior of this aggregate will continue to be evaluated in the light of movements in its

velocity, developments in the economy and financial markets, and the nature of emerging price pressures.

In the implementation of policy for the immediate future, the Committee seeks to increase somewhat the existing degree of pressure on reserve positions. Taking account of indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, somewhat greater reserve restraint would, or slightly lesser reserve restraint might, 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 3 and 6-1/2 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 7 to 11 percent.

Votes for this action: Messrs. Greenspan, Corrigan, Angell, Black, Forrestal, Heller, Hoskins, Johnson, Kelley, LaWare, and Parry.
Vote against this action: Ms. Seger.

Ms. Seger dissented because she viewed current business indicators as already pointing on balance to slower economic expansion, and in the circumstances she did not feel that any added monetary restraint was needed to foster economic conditions consistent with progress in reducing inflationary pressures. In the context of already restrained monetary growth, she was concerned that a further increase in the degree of reserve pressure would pose unnecessary risks to interest-sensitive sectors of the economy and ultimately to the sustainability of the expansion itself. She expressed particular concern that the higher interest rates implied by greater monetary restraint would aggravate the condition of financially troubled thrift institutions.

At this meeting the Committee reviewed its current procedure for implementing open market operations against the background of a

marked change over recent months in the relationship between the level of adjustment plus seasonal borrowing and the federal funds rate. The current procedure of focusing on the degree of reserve restraint, as indexed by borrowed reserves, had been implemented with some flexibility in recent weeks in light of the substantial shortfall of borrowing in relation to expectations. The policy results had been satisfactory, but some members proposed that consideration be given to focusing more directly on the federal funds rate in carrying out open market operations, particularly if uncertainty about the borrowing - federal funds relationship were to persist. Others felt that despite its drawbacks the current procedure had a number of advantages, including that of allowing greater scope for market forces to determine short-term interest rates. The Committee concluded that no changes in the current procedure were needed at this time, but that flexibility would remain important in accomplishing Committee objectives under changing circumstances.