Minutes of Federal Open Market Committee Meetings

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each such action, and that it shall include in its annual report to the Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a résumé of the discussions that led to the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings rather than on data as they may have been revised later.

Members of the Committee voting for a particular action may differ among themselves as to the reasons for their votes; in such cases, the range of their views is noted in the minutes. When members dissent from a decision, they are identified in the minutes along with a summary of the reasons for their dissent.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market activities, the Federal Reserve Bank of New York operates under two sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Committee operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 1998. Changes in the instruments during the year are reported in the minutes for the individual meetings.

Authorization for Domestic Open Market Operations

In Effect January 1, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal

Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $8.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) When appropriate, to buy or sell in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates, prime bankers acceptances with maturities of up to nine months at the time of acceptance that (1) arise out of the current shipment of goods between countries or within the United States, or (2) arise out of the storage within the United States of goods under contract of sale or expected to move into the channels of trade within a reasonable time and that are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods; provided that the aggregate amount of bankers acceptances held at any one time shall not exceed $100 million;

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers acceptances of the types authorized for purchase under 1(b) above, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(c), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

Domestic Policy Directive

In Effect January 1, 1998[1]

The information reviewed at this meeting suggests that economic activity continued to grow rapidly in recent months. Nonfarm payroll employment increased sharply in October and November; the civilian unemployment rate fell to 4.6 percent in November, its low for the current economic expansion. Industrial production continued to advance at a brisk pace in October and November. Retail sales were unchanged on balance over the two months after rising sharply in the third quarter. Housing starts increased slightly further in October and November. Available information suggests on balance that business fixed investment will slow from the exceptionally strong increases of the second and third quarters. The nominal deficit on U.S. trade in goods and services widened significantly in the third quarter from its rate in the second quarter. Price inflation has remained subdued, despite some increase in the pace of advance in wages.

Short-term interest rates have registered small mixed changes since the day before the Committee meeting on November 12, 1997, while bond yields have fallen somewhat. Share prices in U.S. equity markets recorded mixed changes over the period; equity markets in other countries, notably in Asia, have remained volatile. In foreign exchange markets, the value of the dollar has risen over the intermeeting period in terms of both the trade-weighted index of the other G-10 countries and the currencies of a number of Asian countries.

M2 and M3 grew rapidly in November. For the year through November, M2 expanded at a rate slightly above the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat below the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. 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 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on a tentative basis to set the same ranges as in 1997 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth in M2 and M3 over coming months.

Authorization for Foreign Currency Operations

In Effect January 1, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settle-

1. Adopted by the Committee at its meeting on December 16, 1997.

ments, and with other international financial institutions:

Austrian schillings	Italian lire
Belgian francs	Japanese yen
Canadian dollars	Mexican pesos
Danish kroner	Netherlands guilders
Pounds sterling	Norwegian kroner
French francs	Swedish kronor
German marks	Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements (“swap” arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount (millions of dollars equivalent)
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	3,000
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1(A) above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non–market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board Members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account (“Manager”), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors’ Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

Foreign Currency Directive

In Effect January 1, 1998

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency (“swap”) arrangements with selected foreign central banks and with the Bank for International Settlements.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Procedural Instructions with Respect to Foreign Currency Operations

In Effect January 1, 1998

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account (''Manager''), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System, and about any operations that are not of a routine character.

Meeting Held on February 3–4, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, February 3, 1998, at 2:30 p.m. and continued on Wednesday, February 4, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Ms. Phillips
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Ms. Browne, Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Promisel, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Mr. Slifman, Associate Director, Division of Research and Statistics, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

Messrs. Brayton[2] and Rosine,[2] Senior Economists, Division of Research and Statistics, Board of Governors

Ms. Garrett and Mr. Nelson,[2] Economists, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Rives, First Vice President, Federal Reserve Bank of St. Louis

Messrs. Beebe, Eisenbeis, Hunter, Ms. Krieger, Messrs. Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Chicago, New York, Philadelphia, Minneapolis, and Dallas respectively

Mr. Hetzel, Vice President, Federal Reserve Bank of Richmond

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 1998, and ending December 31, 1998, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

2. Attended portions of meeting relating to the Committee's review of the economic outlook and establishment of its monetary and debt ranges for 1998.

William J. McDonough, President of the Federal Reserve Bank of New York, with Ernest T. Patrikis, First Vice President of the Federal Reserve Bank of New York, as alternate;
Cathy E. Minehan, President of the Federal Reserve Bank of Boston, with Edward G. Boehne, President of the Federal Reserve Bank of Philadelphia, as alternate;
Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, with Michael H. Moskow, President of the Federal Reserve Bank of Chicago, as alternate;
Robert D. McTeer, Jr., President of the Federal Reserve Bank of Dallas, as voting alternate pending the election of a President of the Federal Reserve Bank of St. Louis;
Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, with Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after December 31, 1998, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

Alan Greenspan	Chairman
William J. McDonough	Vice Chairman
Donald L. Kohn	Secretary and Economist
Normand R.V. Bernard	Deputy Secretary
Joseph R. Coyne	Assistant Secretary
Gary P. Gillum	Assistant Secretary
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Michael J. Prell	Economist
Edwin M. Truman	Economist

Lynn E. Browne, Stephen G. Cecchetti, William G. Dewald, Craig S. Hakkio, David E. Lindsey, Larry J. Promisel, Thomas D. Simpson, Mark S. Sniderman, and David J. Stockton, Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Committee after December 31, 1998.

By unanimous vote, Peter R. Fisher was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.

Secretary's note: Advice subsequently was received that the selection of Mr. Fisher as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York.

On the recommendation of the Manager, the Committee at this meeting unanimously approved two changes in the Authorization for Domestic Open Market Operations.

First, the Committee amended paragraph 1(a) of the Authorization to raise from $8 billion to $12 billion the limit on intermeeting changes in System account holdings of U.S. government and federal agency securities. The increase was the first permanent change in the limit since February 1990, when it was raised from $6 billion to $8 billion. The Manager indicated that the Committee had approved temporary increases several times during the past year and that the existence of a permanent $12 billion limit would have obviated the need for most of the increases. A permanent increase to $12 billion would reduce the number of occasions requiring special Committee action, while still calling the need for particularly large changes to the Committee's attention. The Committee concurred in the Manager's view that a $4 billion increase was appropriate.

Second, the Committee terminated the Manager's authority to conduct transactions in bankers acceptances. This involved the deletion of paragraph 1(b), which authorized purchases or sales of prime bankers acceptances in the open market, and also the deletion of the reference in paragraph 1(c), which authorized repurchase agreements in such market instruments. The Manager indicate that operations in bankers acceptances were not a practical means of affecting reserves under current circumstances, given the ample availability of U.S. Treasury obligations in the market. Indeed, the Committee previously had decided in 1977 to suspend transactions on an outright basis in bankers acceptances and had completed the System's disengagement from this market in 1984 by instructing the Manager to discontinue the use of repurchase agreements involving bankers acceptances. While those decisions had left open the possibility of resuming transactions in bankers acceptances and no changes had been made in the Authorization, the Committee agreed that the existing authority no longer served a practical purpose. Accordingly, the amended Authorization for Domestic Open Market Operations was unanimously approved in the form shown below.

Authorization for Domestic Open Market Operations

Amended February 3, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank,

under such instructions as the Committee may specify from time to time.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph l(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph l(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

With Mr. Jordan dissenting, the Authorization for Foreign Currency Operations shown below was reaffirmed.

Authorization for Foreign Currency Operations

Reaffirmed February 3, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Austrian schillings	Italian lire
Belgian francs	Japanese yen
Canadian dollars	Mexican pesos
Danish kroner	Netherlands guilders
Pounds sterling	Norwegian kroner
French francs	Swedish kronor
German marks	Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding \$25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements (''swap'' arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	3,000
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations

to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

With Mr. Jordan dissenting, the Foreign Currency Directive shown below was reaffirmed.

Foreign Currency Directive

Reaffirmed February 3, 1998

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks and with the Bank for International Settlements.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Mr. Jordan dissented in the votes on the Foreign Currency Authorization and the Foreign Currency Directive because these policy instruments provide the basis for foreign exchange market transactions. He believes that the primary mission of the Federal Reserve is to achieve and maintain a stable purchasing power of the U.S. dollar. That objective is best achieved when open market transactions are restricted to purchases and sales of U.S. government securities. When compatible with the System's primary objective, foreign exchange transactions are redundant to open market operations. Often, however, foreign exchange transactions conflict with the System's primary objective, requiring opposite adjustments in System holdings of U.S. Treasury obligations. Moreover, holdings of foreign securities expose the Reserve Banks to foreign exchange translation losses resulting from the depreciation of foreign currencies relative to a strong and stable U.S. dollar.

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency Operations shown below were reaffirmed.

Procedural Instructions with Respect to Foreign Currency Operations

Reaffirmed February 3, 1998

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the

Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

On January 16, 1998, the continuing rules, regulations, authorizations, and other instructions of the Committee were distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee's attention before the February 3–4 organization meeting to give members an opportunity to raise any questions they might have concerning them. Members were asked to indicate if they wished to have any of the instruments in question placed on the agenda for consideration at this meeting, and no requests for consideration were received.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 16, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on December 16, 1997. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager of the System Open Market Account also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period from December 17, 1997, through February 3, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook, the ranges for the growth of money and debt in 1998, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economy continued to expand at a robust pace during the closing months of 1997. Both employment and industrial output recorded substantial increases in the fourth quarter. While spending for final goods and services by U.S. residents decelerated noticeably, inventory investment strengthened and the deficit in international trade in goods and services appeared to have narrowed. Tighter labor markets brought some acceleration in wages, but falling import and energy prices helped to hold down price inflation over the closing months of the year.

Labor demand expanded rapidly in the fourth quarter; a sharp increase in nonfarm payroll employment in December followed large advances in October and November, and the average workweek edged up on balance over the three-month period. Job gains were widely spread across industries. In the fourth quarter, new hires in manufacturing accounted for more than half of that sector's total for the year, and construction employment also registered an unusually large rise compared with earlier in 1997. Job growth surged in retail trade and persisted at a rapid pace in service-producing industries. The civilian unemployment rate, at 4.7 percent in December, was near its low for the current economic expansion.

Industrial production continued to advance at a brisk pace in the fourth quarter. Growth in the manufacturing of durable goods remained strong despite sharply slower, though still substantial, expansion in the output of computing and office equipment. The production of nondurable goods picked up after having been sluggish earlier in the year. Capacity utilization in manufacturing was at a relatively high rate in the fourth quarter, but available information suggested few bottlenecks.

Consumer spending, in real terms, rose at a slower though still appreciable rate in the fourth quarter. Purchases of durable goods increased moderately after having surged in the third quarter, and spending on nondurables edged down. By contrast, expenditures for consumer services grew at a somewhat faster rate. Recent surveys indicated that consumer confidence remained at a very high level.

Housing demand continued to exhibit considerable strength at year-end in the context of sharp declines in fixed mortgage rates in recent months, further sizable gains in employment and household income, and very positive consumer assessments of homebuying conditions. Applications for mortgages to purchase homes increased to a new monthly high in December; the pace of sales of existing homes rose further in the fourth quarter; and sales of new homes in November (latest available monthly data) were at their highest monthly pace in more than ten years. Housing starts edged lower in December but remained close to the highs of the current expansion.

After unusually strong increases earlier in the year, real business fixed investment declined slightly in the fourth quarter. However, the outlook for further growth remained positive, with corporate cash flow still healthy and the user cost of capital still low. Data on shipments of nondefense capital goods in December indicated a rebound in business spending on capital goods, notably for office, computing, and communications equipment, after sizable declines in the October–November period. Business spending on nonresidential structures declined slightly in the fourth quarter despite rising real estate prices and falling vacancy rates.

The pace of business inventory investment evidently picked up somewhat in the fourth quarter. In manufacturing, inventories climbed further in November (latest monthly data available), and the stock–shipments ratio was at the top of its narrow range for the past twelve months. The accumulation of wholesale stocks continued its strong upward trend, and by November the inventory–sales ratio for the wholesale sector had reversed its 1996 decline. In the retail sector, inventories declined slightly in November after having changed little in October; the inventory–sales ratio for this sector was near the bottom of its range for the last twelve months.

The nominal deficit on U.S. trade in goods and services narrowed substantially on average in October and November from its level in the third quarter. The value of exports rose appreciably in the October–November period, with the largest increases occurring in automotive and agricultural products. The average value of imports for October and November changed little from the third-quarter rate. Imports of consumer goods and machinery rose, but they were about offset by declines in automotive products, computers, and, to a lesser extent, a wide variety of other products. The available information indicated that economic expansion remained healthy in most of the foreign G-7 countries, although slowing somewhat from the third quarter. In Asia, weakness in economic activity in Japan continued into the fourth quarter, and persisting financial turmoil was having strong adverse effects on the economies of a number of developing countries.

Consumer price inflation remained low in December, damped by a sizable further drop in energy prices and a small decline in food prices. Excluding food and energy items, an acceleration in the costs of services, notably medical care and shelter, provided a slight boost to core consumer price inflation in December. For the year as a whole, prices of core consumer items rose considerably less than in 1996, in part reflecting the effect of declining import prices. At the producer level, prices of all finished goods and of the core finished goods component declined further in December. For the year 1997, the core producer price index was little changed after a relatively small rise the previous year; the total index, weighed down by falling prices of finished food and energy items, partially reversed its 1996 increase. Prices also remained subdued at earlier stages of processing in 1997, with prices of crude materials falling substantially. Labor costs, as measured by the hourly compensation of private industry workers, increased at appreciably faster rates in the fourth quarter and for the year.

At its meeting on December 16, 1997, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging around 5½ percent. In light of the increased uncertainties in the outlook and the possibility that the next change in policy might be in either direction, the Committee adopted a directive that did not include a presumption about the likely direction of any adjustment to policy during the intermeeting period. Reserve market conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining reserve conditions consistent with the intended federal funds rate average of around 5½ percent, and the effective rate averaged close to that level despite some largely anticipated upward pressures in reserve markets around year-end. Most other domestic market interest rates moved down on balance during the intermeeting period, apparently as a result of increased concerns over the turbulence in Asia and its potential implications for the U.S. economy. Share prices in U.S. equity markets moved up slightly on net, perhaps partly in response to the bond market rally, while equity markets in some other countries, notably in Asia, remained unsettled.

In foreign exchange markets, the dollar appreciated on balance over the intermeeting period. The dollar rose considerably further against the currencies of many of the emerging market economies in Asia amid continuing market concerns about the adequacy of reforms that would be undertaken in the affected countries and the magnitude and availability of international financial assistance that would be needed to support those efforts. The dollar also gained slightly on average in relation to the currencies of the other G-10 currencies. A sizable advance by the dollar relative to the German mark was largely reversed late in the intermeeting period; incoming information suggesting greater strength in the German economy lifted the value of the mark and tended to offset growing concern about the likely effect of the Asian crisis on Germany. The dollar declined somewhat on balance against the yen as heightened prospects for domestic fiscal stimulus in Japan fostered hopes of a less weak performance of the Japanese economy.

M2 and M3 continued to grow at relatively rapid rates in December and apparently also in January. Recent gains in nominal income evidently underpinned much of the greater-than-expected strength in M2 in January; also contributing were a pickup in mortgage refinancing activity and, perhaps, depositor transfers of funds from market instruments whose yields had declined relative to those on M2 assets. Large increases in repurchase agreements contributed to rapid growth of M3 in January; the rise in M3 helped to finance further solid expansion of bank credit. From the fourth quarter of 1996 to the fourth quarter of 1997, M2 increased at a rate somewhat above the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt expanded in 1997 at a pace somewhat below the middle of its range, reflecting the slow rise in the federal debt.

The staff forecast prepared for this meeting indicated that the expansion of economic activity would slow appreciably during the next few quarters and remain moderate in 1999. The staff analysis suggested that slower growth abroad and the considerable rise that already had occurred in the foreign exchange value of the dollar would exert substantial restraint on the demand for U.S. exports and subject domestic producers to even stiffer competition from imports. An anticipated reduction in the desired rate of inventory accumulation would add to the restraint on the expansion. As output growth slowed, pressures on resources would be expected to diminish somewhat. Nonetheless, it was expected that, consistently measured, inflation would increase to some degree over the ensuing period through 1999, owing in part to an abatement of restraining forces from foreign exchange and oil markets.

In the Committee's discussion of current and prospective economic conditions, members commented that the performance of the economy continued to be quite favorable. They noted that the economy had entered the new year with considerable momentum and very few indications that growth was moderating from what appeared to be an unsustainable rate. Nonetheless, their assessments of the various factors bearing on the outlook led them to conclude that appreciably slower economic growth was in the offing for the year ahead, possibly to a pace in the vicinity of current estimates of the economy's long-run growth potential. Many emphasized that the prospects for declining net exports as a consequence of the dollar's appreciation and the crises in a number of Asian economies were a key factor in the outlook for some slowing in the expansion. In addition, a moderating rate of inventory accumulation appeared likely after the rapid buildup during 1997. At the same time, high levels of confidence and generally accommodative financial conditions supported expectations of persisting, though likely diminishing, strength in consumer spending and business fixed investment. The members acknowledged that their forecasts were subject to a great deal of uncertainty because there was little precedent to guide them in their evaluation of the extent and likely effect of Asian market turmoil. In the circumstances, the risks of a considerable deviation on the upside or the downside of their current forecasts were unusually high. Partly as a consequence, the outlook for inflation was quite tentative as well. Moreover, questions persisted about the level and growth of sustainable output. Members observed that price inflation had remained subdued, and by some measures had declined, in recent months despite very tight labor markets and indications of somewhat faster increases in labor compensation.

In keeping with the practice at meetings just before the Federal Reserve's semiannual monetary policy report to the Congress and the Chairman's associated testimony, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members had provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the year ahead. Based on developments over the second half of 1997, the central tendency of the projections for 1998 now pointed to slightly more strength in real GDP and appreciably less inflation than the forecasts prepared at the time of the July 1997 meeting. The forecasts of the rate of expansion in real GDP in 1998 had a central tendency of 2 to 2¾ percent and a full range of 1¾ to 3 percent. Such growth was expected to be associated with a civilian unemployment rate in a range of 4½ to 5 percent in the fourth quarter of this year, implying little or no change from the current level. With regard to nominal GDP growth in 1998, the forecasts were mainly in a range of 3¾ to 4½ percent, with an overall range of 3½ to 5 percent. Projections of the rate of inflation, as measured by the consumer price index, had a central tendency of 1¾ to 2¼ percent, on the high side of the outcome for 1997 when the rise in the index was held down by damped increases in food prices and declines in energy prices. These forecasts took account of likely further technical improvements in the CPI by the Bureau of Labor Statistics that would trim the reported rate. The projections were based on individual views concerning what would be an appropriate policy over the projection horizon to foster the Committee's longer-term goals.

The members stressed that the potential extent of the negative effects of developments in Asia on the nation's trade balance represented a key uncertainty in the economic outlook. On the whole, those effects had been quite limited thus far. Anecdotal reports indicated that a number of domestic producers, notably of agricultural, lumber, and wood products, had experienced some cancellations or postponements of orders from Asian customers and there was some evidence of increased imports from those nations. Exports to affected Asian nations were likely to be held back by declining incomes and rising prices of U.S. products in local currencies, and reportedly also by difficulties that importing firms in Asia were encountering in securing financing. The eventual effects of the Asian financial turmoil on the U.S. trade balance and the overall economy were unknown—in part because in some key countries needed reforms had yet to be implemented and markets to stabilize—but they clearly seemed likely to become more pronounced in coming months. Net exports also would be held down by the appreciation of the dollar against the currencies of the industrial countries that had occurred earlier in 1997 before the Asian crisis intensified.

Another factor viewed as likely to exert a moderating effect on the growth of economic activity was the expectation of some slowing in inventory investment. In the past year, businesses had added to inventories at a rate that exceeded the rise in final sales, and somewhat reduced accumulation to a pace more in line with that of final sales was seen as a reasonable expectation. Some members expressed reservations, however, about the extent of any weakening in inventory accumulation in light of the relatively favorable economic conditions that they believed were likely to persist over the year ahead.

Members viewed further growth in consumer spending as likely to remain the major factor in sustaining the expansion in overall economic activity. Consumer sentiment was at or close to historically high levels according to recent surveys, evidently reflecting the strong uptrend in employment and income and to some extent the very large cumulative increase in stock market wealth over the course of recent years. Some also noted that consumer debt burdens, while large, were manageable and that such burdens would be lessened for many consumers by their refinancing of home mortgages at the lower mortgage rates now prevailing. Evidence of strength in the consumer sector was supported by upbeat anecdotal reports of retail sales during the holiday season and more recently. While the growth in personal expenditures was likely to moderate somewhat from its recent pace, members did not rule out a more ebullient consumer sector in the context of substantial further growth in disposable incomes, favorable financing conditions for purchases of homes, automobiles, and other consumer durables, and the high level of stock market prices.

Business fixed investment also was expected to provide substantial support to continued economic expansion, though some moderation in purchases of business equipment seemed likely after the exceptionally rapid rates of growth in such investments in recent years. Business sentiment remained generally optimistic, and both debt and equity financing continued to be readily available on attractive terms to most business borrowers. However, early signs of faltering profit trends in some industries, in part related to developments in Asia, appeared to have introduced a cautionary note among some business planners. Members also referred to emerging signs of speculative overbuilding in some areas, especially of commercial structures. Even so, in the absence of unanticipated weakness in consumer expenditures, a variety of favorable factors seemed likely to sustain relatively robust spending on business structures and equipment over the year ahead. The latter included increased opportunities to cut costs and enhance efficiency by investing in relatively inexpensive high tech equipment in a period characterized by strong competition in many markets and rising labor compensation associated with tight labor markets.

Residential construction activity had remained relatively robust in recent months and was expected to be well maintained over coming quarters. Positive indications for the housing outlook included relatively low mortgage interest rates, very favorable measures of cash flow affordability, and quite positive homebuying attitudes as expressed in recent surveys. While these factors were expected to help sustain the housing sector over coming months, members noted that housing construction had been high for some time and some cited anecdotal evidence of softening activity in some parts of the country. On balance, only modest, if any, slippage from current levels of home construction activity seemed likely over the year ahead.

With regard to the outlook for inflation, members referred to widespread indications of increasingly tight labor markets and to statistical and anecdotal reports of faster increases in labor compensation. Labor cost increases in recent quarters had been especially rapid in a large segment of the service sector, where foreign competition was not a factor. Some members commented, however, that there were reasons to discount the sharp fourth-quarter increase in the employment cost index because to a large extent it was the result of nonrecurring developments in a limited number of industries. Despite the upward trend in labor compensation, gains in productivity clearly had kept increases in unit labor costs at a very modest level; and with unit nonlabor costs continuing to decline, overall unit cost increases had remained not far above zero. In these circumstances—and in the context of highly competitive conditions in many markets, declines in input prices and in the prices of many commodities, including oil—rising labor costs seemed to pose little risk of an upward impetus to inflation in coming months.

The longer-run outlook for inflation was more clouded and under some scenarios less promising. Inflation expectations had been moving down according to recent surveys, and in the context of relatively modest increases in consumer prices expected over coming months such expectations could continue to move lower, thereby constraining increases in compensation and prices. Nonetheless, some of the factors that had helped to moderate price increases—including declining oil prices, the appreciation of the dollar, and restrained increases in health insurance costs—were not likely to continue to exert benign effects on inflation as time went on. More fundamentally, the productivity improvement that had held down producer costs could not necessarily be counted on to continue to offset such costs, especially if the economic expansion remained sufficiently rapid to put additional pressures on available labor resources.

In keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey–Hawkins Act), the Committee reviewed the ranges for growth of the monetary and debt aggregates in 1998 that it had established on a tentative basis at its meeting in July 1997. Those ranges included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The associated range for growth of total domestic nonfinancial debt was provisionally set at 3 to 7 percent for 1998. The tentative ranges for 1998 were unchanged from the ranges that had been adopted initially for 1995 (in July of that year for M3).

In reviewing the tentative ranges, the members took note of a staff projection indicating that, given the members' expectations for the performance of the economy and prices and assuming no major changes in interest rates, M2 likely would grow in 1998 in the upper half of its tentative range, and M3 somewhat above the top of its range. The staff analysis anticipated that the velocity of M2 would continue its recent pattern of relatively stable behavior that was more in line with historical experience than had been the case in the early 1990s. The velocity of M3 was projected to continue to decline at a somewhat faster rate than historical experience would indicate, reflecting the greater use by business firms of institution-only money market funds as a cash management tool and the needs of depository institutions for appreciable non-M2 funding to finance brisk loan growth. The staff projected that the debt of the domestic nonfinancial sectors would grow around or perhaps slightly above the middle of its tentative range, reflecting the credit needs of businesses facing a weaker earnings outlook and larger merger-related retirements of equity.

In their discussion of the ranges for M2 and M3, the members noted that the apparently greater predictability of velocity in recent years could not be counted on to persist, given changes in financial markets that had made investment alternatives more readily available. As a consequence, substantial uncertainty still surrounded projections of money growth consistent with the Committee's basic objectives for monetary policy. In this environment, the members did not see any firm basis for deviating from their recent practice of setting ranges that, assuming velocity behavior in line with historical patterns, would serve as benchmarks for monetary expansion consistent with longer-run price stability and a sustainable rate of real economic growth. The tentative ranges for 1998 had been derived in this way, and Committee members saw no reason to change those ranges at this time. Indeed, adjusting the ranges to center them more closely on growth rates deemed likely to be more consistent with the Committee's expectations for economic activity and prices could foster the misinterpretation that the Committee had become much more confident of the stability and predictability of velocity and was placing greater emphasis on M2 and M3 as gauges of the thrust of monetary policy. Several members commented, however, that the adoption of ranges centered on the Committee's expectations for growth of the monetary aggregates should be reconsidered in the future if the members were to become more confident about the relationship between the growth of the money and measures of aggregate economic performance. The Committee also agreed that the range for nonfinancial debt for 1998 should be left unchanged. The tentative range readily encompassed the pace seen as likely to be associated with the members' forecasts for economic activity and prices.

Accordingly, the following statement of longer-run policy for 1998 was approved for inclusion in the domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2

and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, McTeer, Meyer, and Mses. Minehan, Phillips, and Rivlin. Votes against this action: None.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance. The economy currently was performing very well and the outlook over the near term was for subdued inflation and continued solid economic growth. Over a longer horizon, the range of possible outcomes was unusually wide, and the direction that policy would need to move to promote sustained expansion and damped inflation was unclear. At this point, the extent to which the still largely anticipated external drag from events in Asia would offset the strong upward momentum in domestic demand was a source of major uncertainty. In addition, it was impossible to predict whether or when the tightness in labor markets would exert a more pronounced effect on labor costs and ultimately on price inflation. Even the thrust of the current stance of monetary policy as it was transmitted through financial markets was open to some question. On the one hand, a real federal funds rate that was on the high side of historical experience and a substantially stronger dollar suggested some restraint. From a different perspective, however, financial conditions seemed to be quite stimulative as evidenced by lower nominal and perhaps real intermediate and long-term interest rates, rising equity prices, ready credit availability, and rapid growth of the broad measures of money and credit. While the members differed to some extent in their forecasts of major trends in the economy and in the risks of alternative outcomes, they agreed that, under foreseeable circumstances, needed adjustments to policy probably could be made on a timely basis once the balance of underlying forces became more evident. Accordingly, a steady policy would not incur an unacceptable risk of a seriously deteriorating economic performance. In the interim, the greater risk would be to make a preemptive policy move on the basis of inadequate evidence regarding underlying economic trends.

In the Committee's discussion of possible intermeeting adjustments to policy, all the members agreed that prevailing uncertainties indicated the desirability of retaining a symmetric instruction in the directive. While a number of members expressed the view that the next policy move was likely to be a tightening action and one member saw a greater probability of an easing action, the uncertainties were sufficiently great to warrant remaining sensitive to the need for a policy change in either direction. Accordingly, a symmetric directive would signal the Committee's readiness to respond promptly to developments that might threaten the economy's satisfactory performance.

At the conclusion of the Committee's discussion, all the members indicated their support of a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent, and all also favored a directive that did not include a presumption about the direction of a change, if any, in the stance of policy during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the members decided that a slightly higher or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that economic activity continued to grow rapidly during the closing months of 1997. Nonfarm payroll employment increased sharply further in December after posting very large gains in other recent months; the civilian unemployment rate, at 4.7 percent, remained near its low for the current economic expansion. Industrial production continued to advance at a brisk pace in the fourth quarter. Consumer spending rose appreciably in the quarter, and housing starts remained close to the highs of the current expansion. Business fixed investment weakened following exceptionally strong increases in the second and third quarters; nonfarm inventory accumulation appears to have picked up somewhat. The nominal deficit on U.S. trade in goods and services narrowed significantly on average in October and November from its level in the third quarter. Price inflation has remained subdued despite appreciably faster increases in worker compensation in recent months.

Most interest rates have declined on balance since the day before the Committee meeting on December 16, 1997. Share prices in U.S. equity markets have moved up somewhat over the period; equity markets in some other countries, notably in Asia, have remained volatile. In foreign exchange markets, the value of the dollar has risen over the intermeeting period relative to the currencies of several Asian developing countries, but it has registered only a small increase on average in relation to the currencies of major industrial nations.

M2 and M3 continued to grow at relatively rapid rates in December and apparently also in January. From the fourth quarter of 1996 to the fourth quarter of 1997, M2 expanded at a rate somewhat above the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt expanded in 1997 at a pace somewhat below the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, Meyer, McTeer, Mses. Minehan, Phillips, and Rivlin. Votes against this action: None

It was agreed that the next meeting of the Committee would be held on Tuesday, March 31, 1998.

The meeting adjourned at 10:50 a.m.

Donald L. Kohn
Secretary

Meeting Held on March 31, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 31, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Ms. Phillips
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Ms. Browne, Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Promisel, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Mr. Slifman, Associate Director, Division of Research and Statistics, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Rasdall, First Vice President, Federal Reserve Bank of Kansas City

Messrs. Goodfriend, Hunter, Kos, Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Richmond, Chicago, New York, Philadelphia, Minneapolis, and Dallas respectively

Ms. Rosenbaum, Vice President, Federal Reserve Bank of Atlanta

Mr. Rudebusch, Research Officer, Federal Reserve Bank of San Francisco

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on February 3–4, 1998, were approved.

The Report of Examination of the System Open Market Account, conducted by the Board's Division of Reserve Bank Operations and Payment Systems as of the close of business on November 6, 1997, was accepted.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on February 3–4, 1998. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period from February 4, 1998, through March 30, 1998. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that the economy continued to expand rapidly during the early months of 1998. Apparently, strong growth in private domestic spending for consumption, housing, and business equipment more than offset weakness in net exports and a slight moderation in inventory investment. Total employment continued to rise rapidly, but industrial production increased at a considerably slower pace. Despite indications of persisting pressures on employment costs associated with tight labor markets, price inflation abated further, primarily as a consequence of large declines in energy prices.

Nonfarm payroll employment rose sharply further in January and February. Growth in construction jobs was particularly strong, apparently reflecting in part the unseasonably warm weather across much of the country and the need to repair damage caused by ice storms and heavy rains. In addition, service industries continued to post very large employment gains. By contrast, manufacturing payrolls contracted slightly in February after a sizable increase in January. The civilian unemployment rate edged down to 4.6 percent in February, equaling its low for the current economic expansion.

Industrial production edged up on balance in January and February after having increased rapidly in the second half of 1997. Part of the deceleration stemmed from the depressing effect of unusually warm winter weather on the provision of heating services by utilities. The growth of manufacturing production also slowed considerably as a result of downward adjustments to assemblies of motor vehicles and, more generally, weakness in the output of business equipment. With investment in new manufacturing facilities still brisk and manufacturing output posting only a small advance in the January–February period, the factory operating rate eased a little.

Consumers stepped up their spending in the early months of the year; sentiment remained buoyant in the context of continued strong growth in disposable income and further gains in household wealth. Particularly large increases were recorded in expenditures on durable goods, apparel, and general merchandise. Housing demand also strengthened, with sales of existing homes reaching a record high in February and sales of new homes in January (latest data) almost equaling the previous record. Both housing starts and building permits remained on an upward trend.

Business fixed investment seemed to have rebounded from a small decline in the fourth quarter. Shipments of nondefense capital goods, notably of computing equipment whose prices continued to fall sharply, strengthened substantially in January and February. By contrast, expenditures on transportation equipment were sluggish. Despite further declines in vacancy rates and rising real estate prices, business spending on nonresidential construction also seemed to have been lackluster, with such activity not having changed much since last summer.

The pace of business inventory accumulation slowed sharply in January from the fourth-quarter rate. Some of the slowdown reflected a reduction in motor vehicle stocks; the remainder was largely associated with a drop in inventories of nondurable goods at the wholesale level. Inventory–sales ratios for most manufacturing and trade categories were within the ranges experienced over the past year.

The nominal deficit on U.S. trade in goods and services widened substantially in January from its average monthly level for the fourth quarter. The value of exports declined considerably, partly as a result of reduced exports to Asia, but the value of imports changed little. The decrease in exports was mainly in civilian aircraft and other capital goods. The available information indicated that the pace of economic expansion picked up in Europe after having slowed somewhat in the fourth quarter and was still strong on balance in Canada. Economic activity remained weak in Japan and decelerated sharply in Asian countries that had been the focus of financial turmoil.

Consumer prices were little changed on balance in January and February, as substantial declines in energy prices largely offset increases elsewhere. Excluding food and energy items, consumer price inflation picked up somewhat in the first two months of the year from the pace of the second half of 1997; on a year-over-year basis, however, the increase in consumer prices during the twelve months ended in February was slightly smaller than that in the year-earlier period. At the producer level, falling prices for finished energy goods in January and February pulled down the index of prices for all finished items; excluding food and energy, prices were unchanged on balance over the two months. Over the twelve months ended in February, producer price inflation was negligible. Tight labor markets appeared to be putting some upward pressure on labor compensation, but the pickup was limited. The change in average hourly earnings over the twelve months ended in February was only slightly larger than the increase over the year-earlier period.

With economic growth still solid and inflation subdued, the Committee at its meeting on February 3–4, 1998, had adopted a directive that called for maintaining conditions in reserve markets that would be consistent with an unchanged federal funds rate of about 5½ percent. The substantial uncertainties about the future strength of economic activity and inflation suggested that the next change in policy could be in either direction, and the Committee also had agreed that the directive should not contain a presumption about the direction of any change in the stance of policy during the intermeeting period. The reserve market conditions associated with this directive had been expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations throughout the intermeeting period were directed toward maintaining reserve conditions consistent with the intended average for the federal funds rate of around 5½ percent, and the rate fluctuated in a narrow range around that level. By contrast, interest rates in other domestic financial markets generally rose somewhat on balance over the period in response to incoming information that suggested aggregate private demand remained robust. Despite the rise in rates and some erosion in the outlook for near-term corporate profits, share prices in

U.S. equity markets moved up substantially further.

In foreign exchange markets, the dollar appreciated somewhat on balance over the intermeeting period in relation to the currencies of the other major industrial countries. Against a background of weakening growth in Japan and continued uncertainty about the prospects for fiscal stimulus in that country, the dollar rose considerably against the yen. The dollar changed little against the mark and other continental European currencies but declined against the Canadian dollar and the British pound. The dollar also depreciated significantly relative to the currencies of several emerging market economies in Asia, reflecting market assessments that progress had been made in reforming economic policies and financial and commercial practices in most of those countries.

The available information for February and part of March indicated that M2 and M3 expanded more rapidly than the Committee had anticipated at the time of its February meeting. On a quarterly average basis, growth of both monetary aggregates picked up somewhat in the first quarter from already robust rates in the fourth quarter. The increased demand for M2 was perhaps associated in part with the reduced attractiveness of longer-term fixed rate market assets, whose yields had declined significantly relative to the returns on liquid investment components of M2. In addition, households might have been trying to rebalance asset portfolios that had become more heavily weighted in equities as a result of the run-up in stock prices. The pickup in M3 growth reflected a surge in bank issuance of large time deposits to finance strong demands for loans by businesses and households. The expansion of total domestic nonfinancial debt also strengthened over recent months in response to heavy private demands for credit.

The staff forecast prepared for this meeting indicated that the expansion of economic activity would slow appreciably during the next few quarters and remain moderate in 1999. The staff analysis suggested that the surge in household net worth over the past several years would help to support sizable, though gradually diminishing, gains in consumer spending; favorable cash flow affordability would underpin housing demand at a relatively high level; and substantial increases in capital spending would persist until slower growth in business sales and weaker profits began to have a restraining effect in 1999. Reduced growth of foreign economic activity and the lagged effects of the considerable rise that had occurred in the foreign exchange value of the dollar were expected to exert substantial restraint on the demand for U.S. exports over the projection period and to increase the pressures on domestic producers that face import competition. An anticipated slowdown in the pace of inventory accumulation also would restrain domestic production as stocks were brought into balance with the expected lower trajectory for sales. Although pressures on production resources would abate to a degree as output growth slowed, inflation was expected to increase somewhat in response to persisting tightness in labor markets and a diminishing drag from non-oil import prices.

In the Committee’s discussion of current and prospective developments, members commented on the persistence of unusually favorable economic conditions, characterized by strong growth and low inflation, but a number questioned how long these conditions might last without a policy adjustment.

Domestic demand was exceeding expectations and was likely to continue to increase rapidly for some time, supported by accommodative conditions in key segments of financial markets. Developments in foreign trade were moderating demands on domestic resources; but with domestic spending strong, members were becoming more concerned that those developments might not exert enough restraint on aggregate demand to slow the expansion to a sustainable pace in line with the growth of the economy's potential. Despite tightening labor markets, inflation prospects remained quite favorable for a while as a number of factors—some temporary—helped to damp near-term pressures on prices. Nonetheless, in the absence of some slowing in the expansion, labor compensation probably would continue to accelerate and increasingly outpace productivity, adding to pressures on prices.

In their review of the outlook for spending in key sectors of the domestic economy, members saw little reason to anticipate substantial slowing in the growth of consumer or business expenditures in coming quarters, and they also expected housing activity to be maintained at a relatively high level. The recent further increases in equity prices from already high levels played an important role in the assessments of several members. The stock market's rise was viewed as somewhat puzzling, given indications of some slowing in the growth of profits and the potential for earnings disappointments as the expansion in spending moderated and profit margins narrowed in the context of more rapid labor cost increases. So long as a high degree of optimism in the stock market persisted, however, the elevated level of financial wealth and the low cost of capital should continue to boost spending. Consumer expenditures, especially for durable goods, had risen sharply thus far this year, and the factors that had fueled that expansion were still unusually positive. They included large increases in employment and personal incomes, the continuing uptrend in financial wealth relative to disposable income, and, in these circumstances, the persistence of a very high level of consumer confidence. Attractive financing conditions and favorable business confidence also were expected to support substantial further growth in business investment, especially in high tech equipment that was characterized by rapid product improvement and falling prices. Investment in nonresidential structures, notably in office and other commercial markets, seemed likely to strengthen somewhat in response to reduced vacancy rates and sizable increases in rents in many areas; indeed, several members again reported indications of speculative nonresidential construction in some parts of the country. Residential construction was expected to be maintained at a high level, though single-family starts might soften over the next few months after a surge that appeared to have been related to relatively favorable weather conditions during the winter. With mortgage rates at their recent reduced levels and incomes continuing to rise, the cash flow affordability of home ownership was exceptionally favorable.

Developments in two areas of expenditures were thought likely to exert some restraining effect on the overall expansion in economic activity over coming quarters. One was business inventory accumulation, which had exceeded the robust growth in final sales in 1997 and probably would moderate this year as business firms sought to restrain the buildup in their inventories to keep them in better alignment with the expected moderation of gains in sales.

The second, foreign trade developments, also was likely to have a damping influence on the domestic economy. While the lagged effects of the dollar's appreciation and economic conditions in key U.S. trading partners around the world were important factors in this assessment, members focused in this discussion on the effects of weakness in several Asian economies. Conditions in Japan and in key emerging market economies in Asia were still quite fragile, adjustments on the real side of the economy were just beginning to be felt in some cases, and outcomes for economic growth and exchange rates were still very much in doubt. Nonetheless, some progress had been made in putting recovery programs together, and financial markets had seemed to stabilize in several countries. Anecdotal reports of adverse repercussions on individual U.S. firms from the Asian financial turmoil had increased somewhat since the Committee's previous meeting, but the direct overall impact on the U.S. economy was still limited. Indeed, developments in Asia also appeared to have had positive, albeit indirect, effects on domestic demand and prices in the near term by exerting some downward pressure on U.S. interest rates and world oil prices. Prices in the United States of a number of Asian goods and of domestic products competing with those goods had been lowered. Over time, conditions in key Asian economies were thought likely to have a more pronounced retarding effect on the U.S. economy. While the eventual dimensions of that effect remained uncertain, a number of members commented that, on the basis of developments to date, they might turn out to be less negative than had been expected earlier, or at least that some "worst case" outcomes seemed less likely.

With regard to the outlook for inflation, members observed that price inflation remained quite low—in fact, it was still declining by some measures—and there was little evidence of any potential acceleration in current price data or in anecdotal reports from around the country. Nonetheless, as they had at previous meetings, members expressed particular concern about the outlook for prices in the absence of appreciable slowing in the growth of aggregate demand, which appeared to be adding to pressures on labor resources. Anecdotal reports from across the nation continued to suggest exceptionally tight labor markets and growing indications of somewhat faster increases in labor compensation. To date, unit labor costs had been contained by large capital investments and other initiatives that had raised the productivity of labor. But additional improvements in productivity growth could not be counted on to offset further increases in the rate of growth of labor compensation, which were more likely to occur especially if labor markets were to tighten further. Moreover, the effects of a number of special factors that had tended to limit cost pressures and price inflation in recent years were not likely to persist; these included the declines in world oil prices, the subdued increases in the costs of health benefits, and the lagged effects of the appreciation of the dollar. To be sure, the factors that had produced the favorable inflation results of recent years were not all well understood, and consequently expectations of greater price pressures had to be tentative. On balance, though any upsurge in inflation seemed unlikely in the nearer term, the risk that inflation might move higher over the longer run seemed to have increased.

Despite perceptions of a greater risk of rising inflation over time, all but one of the members indicated in the Committee's policy discussion that they preferred, or could accept, a proposal to maintain an unchanged policy stance that also included a shift from the current symmetrical directive to an asymmetrical directive tilted toward restraint. The members agreed that should the strength of the economic expansion and the firming of labor markets persist, policy tightening likely would be needed at some point to head off imbalances that over time would undermine the expansion in economic activity. Most saw little urgency to tighten policy at this meeting, however. The economy might well continue to accommodate relatively robust economic growth and a high level of resource use for an extended period without a rise in inflation. Some members noted that price increases would be held down for a while by the effects of the higher dollar, which had not worked their way fully through domestic prices. Moreover, inflation continued to fall by some measures and inflation expectations still seemed to be adjusting downward toward actual inflation; further declines in these expectations would restrain increases in compensation and prices. Members also noted that the ultimate extent of retarding effects from the financial turmoil in Asia was still uncertain, and several cited the possibility of a downward adjustment in the stock market, perhaps in response to disappointing growth in business profits, that could have an adverse impact on business and consumer confidence. In these circumstances, a preemptive policy move to head off rising inflation could prove premature or perhaps even unwarranted; indeed, in the view of some, a tightening move was not inevitable. Moreover, because a policy action was not currently anticipated, some commented that a tightening could produce an outsized and undesirable response in financial markets. On balance, in light of the uncertainties in the outlook and given that a variety of special factors would continue to contain inflation for a time, the Committee could await further developments bearing on the strength of inflationary pressures without incurring a significant risk that disruptive policy actions would be needed later in response to an upturn in inflation and inflation expectations.

One member indicated a strong preference for an immediate policy tightening move, largely on the grounds that under current conditions relatively rapid growth in money and credit was not consistent with continued progress toward reducing inflation. A number of other members also commented that the strength of the monetary aggregates, especially if it should persist, was suggesting ample liquidity and accommodative financial conditions. In addition, some cited ebullient equity markets and narrow risk spreads in credit markets as additional evidence that financial conditions were not restraining final demands very much. These were factors that they would weigh in their evaluation of the need for, and timing of, a policy tightening move.

The members agreed that they should be particularly sensitive to developments that might signal rising inflation pressures, and in that regard a shift to an asymmetric directive seemed desirable. Such a directive would be consistent with the Committee's judgment that the information that had become available since a symmetric directive was last adopted in February had altered the inflation risks enough to make some tightening a likely prospect in the not too distant future. In that regard several suggested that the need for some policy tightening could well materialize in the near future.

At the conclusion of the Committee's discussion, all but one member supported a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that contained a bias toward the possible firming of reserve conditions and a higher federal funds rate. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with considerable moderation in the growth in M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that economic activity continued to grow rapidly during the early months of 1998. Nonfarm payroll employment increased sharply further in January and February, and the civilian unemployment rate, at 4.6 percent in February, equaled its low for the current economic expansion. However, growth in manufacturing payroll employment was down over the first two months of the year, and factory output decelerated appreciably. Consumer spending has risen considerably further since year-end, and housing activity also has strengthened in recent months. Available indicators point to a sharp rebound in business fixed investment following a small decline in the fourth quarter. Fragmentary data on nonfarm inventories suggest a slower rate of accumulation early in the year. The nominal deficit on U.S. trade in goods and services widened substantially in January from its average monthly rate in the fourth quarter. Despite indications of persisting pressures on employment costs associated with tight labor markets, price inflation has abated further, primarily as a consequence of large declines in energy prices.

Interest rates generally have risen somewhat on balance over the intermeeting period. Share prices in U.S. equity markets have moved up substantially further over the period. In foreign exchange markets, the value of the dollar has increased somewhat over the period in relation to the currencies of other major industrial nations, but it has depreciated relative to the currencies of most emerging market economies in Asia.

Growth of M2 and M3 picked up somewhat in the first quarter from already robust rates in the fourth quarter. Expansion of total domestic nonfinancial debt also has strengthened over recent months.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with considerable moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Mses. Minehan, Phillips, Mr. Poole, and Ms. Rivlin. Vote against this action: Mr. Jordan.

Mr. Jordan dissented because growth rates of various measures of money and credit in the second half of 1997 and the first quarter of this year were not consistent in his view with continued progress in reducing inflation. Recent price statistics understated the trend rates of inflation. The one-time effects of falling oil prices, lower food prices, and recent appreciation of the dollar on foreign exchange markets provided only a temporary reduction of inflation. While some reacceleration of reported rates of inflation was probably unavoidable, sustained rapid money growth would risk even higher inflation in future years. The durability of the economic expansion would be jeopardized by price and wage decisions reflecting expectations that the purchasing power of the dollar would decline at faster rates in the future. Once such expectations became imbedded in the economy, even stronger policy actions would be required in order to reestablish a downward trend of inflation.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 19, 1998.

The meeting adjourned at 1:05 p.m.

Donald L. Kohn
Secretary

Meeting Held on May 19, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 19, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Ms. Phillips
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Ms. Browne, Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Simpson, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Fox, Deputy Congressional Liaison, Office of Board Members, Board of Governors

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

Ms. Garrett, Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Kumasaka, Research Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Eisenbeis, Goodfriend, Hunter, Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Chicago, Philadelphia, Minneapolis, and Dallas respectively

Messrs. Altig, Bentley, and Judd, Vice Presidents, Federal Reserve Banks of Cleveland, New York, and San Francisco respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 31, 1998, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets during the period March 31, 1998, through May 18, 1998. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period March 31, 1998, through May 18, 1998. By unanimous vote, the Committee ratified these transactions.

The Manager informed the Committee of his intention to discuss with market participants proposed changes in the procedures for lending securities from the System Open Market Account. The changes would be intended to adapt the lending program to the evolving structure of the U.S. Treasury securities market. They are designed to make System securities lending more effective at helping to relieve occasional significant shortages of particular securities, which could cause disruptions to the market. In a brief discussion, Committee members sought clarification of some of the proposed details of the new program and how it would fit with the Federal Reserve's broader responsibilities. Action to amend paragraph 2 of the Authorization for Domestic Open Market Operations would be required at a later date when the details of the new program had been decided upon after discussions with market participants.

The Committee then turned to a discussion of the economic and financial outlook, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economy continued to expand rapidly in 1998. Strength in consumption, business outlays for durable equipment, and homebuilding boosted growth in domestic final demand to a very rapid pace in the first quarter, and there had been indications of slower expansion since then. However, weakening net exports were exerting a considerable drag on economic growth. Moreover, the extraordinary pace of inventory investment thus far this year might foreshadow less robust expansion ahead. Payroll employment remained on a brisk uptrend, but industrial production decelerated sharply after having surged in the second half of last year. Despite indications of persisting pressures on employment costs associated with tight labor markets, consumer price inflation remained subdued, importantly reflecting large declines in energy prices.

Nonfarm payroll employment registered another large increase in April after a small decline in March; these data, along with the still-low level of initial claims for unemployment insurance in recent weeks, suggested that labor demand had remained robust thus far in 1998. Hiring in the trade, finance and real estate, and services industries was brisk in April; employment in construction retraced part of an apparently weather-related drop in March. The number of manufacturing jobs declined in April for a second consecutive month. The civilian unemployment rate fell sharply, to 4.3 percent in April, after having averaged around 4¾ percent since last November.

Industrial production rose somewhat over March and April after having weakened earlier in the year. Part of the slowdown this year, following rapid growth in the second half of last year, was attributable to weakness in utility output associated with unusually warm winter weather across much of the country. More importantly, though, manufacturing output had changed little on balance in recent months. In April, a pickup in the production of business equipment, particularly of information processing equipment, was largely offset by further declines in the output of construction supplies, basic metals, and nondurable materials. The production of consumer goods was unchanged. The factory operating rate eased further in April, reflecting the continuing brisk expansion in manufacturing facilities and slow growth in output.

Consumer spending had remained strong this year in the context of robust gains in income and household net worth and of very favorable consumer sentiment. Total retail sales rose appreciably in April, boosted by increases in purchases of automobiles and nondurable goods. Housing demand and residential construction activity also continued to increase at a rapid pace this year. Home sales were at very high levels, reflecting the continuing improvement in housing affordability as a result of declining mortgage rates. Although housing starts slipped in April, they remained at an elevated level.

Business fixed investment rebounded sharply in the first quarter from a small decline in the fourth quarter of 1997. A surge in expenditures on producers' durable equipment, notably on computers, communications equipment, and heavy trucks, more than offset continued weakness in outlays for nonresidential structures. While available indicators pointed to further substantial gains in equipment purchases over coming months, data on construction contracts offered little evidence of a pickup in nonresidential construction activity in the near term, even though vacancy rates were declining and office rents were rising.

Business inventories increased at a very rapid pace in the first quarter, but with sales strong, inventory–sales ratios remained within their ranges over the past year. In manufacturing, stock accumulation slowed in March after having increased fairly rapidly in January and

February. At the wholesale level, inventories rose about in line with sales during the quarter, and in the retail sector inventories built up at a greatly accelerated pace in the first quarter.

The nominal deficit on U.S. trade in goods and services widened substantially in January and February from its average monthly rate in the fourth quarter. The value of exports declined considerably in the January–February period, with most of the drop attributable to reduced sales to Asian countries. The decrease in exports was concentrated in agricultural products, industrial supplies, and machinery. The value of imports rose slightly, largely reflecting higher amounts of imported automotive products and higher service payments. The available information suggested that economic growth in continental Europe strengthened in the first quarter, with strong domestic demand apparently offsetting the effects of Asian turmoil on foreign trade. Robust domestic demand also continued to buoy the Canadian economy. By contrast, economic activity in Japan contracted in the first quarter and decelerated sharply further in Asian countries that had experienced financial turmoil.

Consumer prices were unchanged in March and rose moderately in April. Energy prices were down slightly further in April after having declined markedly in previous months, and food prices increased a little; excluding food and energy, consumer price inflation picked up in April as prices of services accelerated and prices of tobacco surged higher. Over the course of recent months, core consumer inflation had accelerated to rates that were somewhat above those registered earlier. Even so, on a year-over-year basis, the increases in total and core consumer prices were substantially smaller over the twelve months ended in April than they had been in the year-earlier period; falling import prices apparently helped damp the goods component of the index. At the producer level, price inflation of finished goods other than food and energy picked up a bit in April, but it was considerably lower over the twelve months ended in April than over the year-earlier interval. Inflation at earlier stages of production also remained subdued. The rate of increase in hourly compensation of private industry workers slowed in the first quarter, reflecting smaller advances in both the wage and benefit components of the index; however, compensation costs accelerated appreciably on a year-over-year basis, primarily as a result of faster growth in wages and salaries.

At its meeting on March 31, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging around 5½ percent. However, in light of increased concerns that growth in aggregate demand might outpace the expansion of the economy's potential for some time, possibly generating inflationary imbalances in labor markets, the Committee decided that the directive should include a bias toward the possible firming of reserve conditions and a higher federal funds rate. The reserve conditions associated with this directive were expected to be consistent with considerable moderation in the growth in M2 and M3 over the months ahead.

Open market operations throughout the intermeeting period were directed toward maintaining reserve conditions consistent with the intended average of around 5½ percent for the federal funds rate. Though tax flows were heavy at times and reserves were drained from depository institutions as tax payments spilled into Treasury deposits at the Federal Reserve Banks, the federal funds rate averaged a little below its intended level over the period. Most other market interest rates declined slightly on balance over the intermeeting period; incoming data suggested that labor markets remained tight and that the economy retained considerable upward momentum, but market participants evidently gave greater weight to information indicating that wage and price inflation was well contained in the first quarter. Share prices in U.S. equity markets rose further despite some reports of soft corporate earnings, and equity prices in most other industrial countries also reached new highs.

In foreign exchange markets, the trade-weighted value of the dollar in terms of major currencies changed little on balance over the period. The dollar declined considerably against the German mark and other continental European countries amid signs of strong growth in the German economy and further progress in resolving the outstanding issues associated with next year's launch of the euro; French and German interest rates also rose slightly over the period. The dollar appreciated somewhat against the yen; the announcement of a large fiscal stimulus package and Japan's intervention in support of the yen did not offset indications of further weakening in the Japanese economy and related declines in Japanese interest rates. Other Asian financial markets came under renewed pressure after a brief period of relative calm. The currencies of several key Asian emerging market economies depreciated considerably against the dollar; and in sharp contrast to the performance of equity markets in most industrial countries, prices in Asian equity markets declined substantially on balance over the period to near their lows of late 1997 or early 1998.

M2 and M3 expanded briskly further in April, but data for late April and early May showed M2 declining and M3 leveling out; much of the fluctuation in M2 during the April–May period appeared to be related to movements of funds associated with unusually heavy nonwithheld tax payments and a surge in mortgage refinancings to take advantage of lower long-term rates. On balance, the underlying growth of these aggregates seemed to be slowing from the pace of the first quarter. The moderation in M3 partly reflected a reduced need for non-M2 sources of funds at a time when bank credit expansion seemed to be slowing. Growth of total domestic nonfinancial debt apparently had slipped somewhat after picking up earlier in the year.

The staff forecast prepared for this meeting indicated that the expansion of economic activity would slow considerably during the next few quarters and remain moderate in 1999. Reduced growth of foreign economic activity and the lagged effects of the sizable rise that had occurred in the foreign exchange value of the dollar were expected to place substantial restraint on the demand for U.S. exports and to add to the pressures on domestic producers to hold down prices to meet import competition. An anticipated sharp slowdown in the pace of inventory accumulation also would damp domestic production as the growth of stocks was brought into balance with the expected more moderate trajectory of final sales. The staff analysis suggested that further strong gains in income, along with the surge in household net worth over the past several years, would support brisk, though gradually diminishing, gains in consumer spending. Housing demand, fostered by the favorable cash flow affordability of home ownership, was expected to remain at a generally high level, though the anticipated slowing in income growth over the projection period would damp residential construction activity somewhat. Substantial increases in capital spending would continue, but slower growth in business sales and profits would produce a gradual deceleration. While pressures on production resources were likely to abate to a degree as output growth slowed, inflation was expected to increase somewhat from its recent pace in response to rising compensation costs associated with persisting tightness in labor markets, a limited rebound in energy prices, and a diminishing drag on non-oil import prices.

In the Committee's discussion of current and prospective economic developments, members noted the exceptional strength in domestic final demand and viewed robust further expansion in such demand as highly likely. Final purchases were being supported by accommodative financial conditions, especially a rising equity market, by ebullient consumer sentiment, and by business spending on productivity-enhancing equipment. While there were limited indications of weakness in some sectors of the economy—such as manufacturing, energy, and agriculture in some areas—the members did not see conclusive evidence of appreciable moderation in the pace of the overall economic expansion. Nonetheless, they generally believed that substantial moderation in the expansion was a likely prospect in coming quarters, largely as a consequence of a marked slowing in inventory investment from the clearly unsustainable pace of the first quarter and, to a lesser extent, from some further weakness in net exports. The outlook for the latter was especially uncertain, and the weakness could be greater than previously anticipated owing to renewed turmoil in emerging Asian economies and pronounced weakness in Japan. Whether the moderation in U.S. economic growth would be sufficient to forestall cost increases arising from tight labor markets that in turn would add to pressures on prices was open to question. To date, developments in business costs had been relatively benign, owing to an important extent to somewhat faster productivity growth. This circumstance and a number of one-time influences holding down costs and prices had contained inflation at rates that were lower than those seen in several decades, and probably would continue to do so for a while. But the members generally were concerned that inflation might begin to rise over the intermediate term, especially if labor markets tightened further.

In their assessment of the factors underlying the persisting strength of aggregate final demand, members took particular note of the effect of accommodative financial conditions. The rapid growth in consumer spending was being bolstered by large gains in stock market wealth; and the strength in housing and other interest-sensitive consumer expenditures also reflected declines in nominal, and perhaps in real, intermediate- and long-term interest rates and the ample availability of loans. Likewise, the ready availability of equity and debt financing on favorable terms was a key factor in the continuing robust growth of business investment. Indeed, some members expressed concern that the widespread perceptions of reduced risk or complacency that had bolstered equity prices beyond levels that seemed justified by fundamentals were beginning to be felt in a variety of other markets as well, including commercial and residential properties, business ventures, and land. In the view of a number of members, rapid growth of the monetary aggregates, though it had slowed very recently, was a further indication that financial conditions were not restraining economic activity.

Despite the failure of domestic demand to moderate in line with their earlier expectations, the members were persuaded that appreciable slowing in the growth of economic activity was a likely prospect over the course of coming quarters even though its exact timing and extent were unknown. Key elements in this assessment were the outlook for inventories and net exports. The surge in inventory accumulation in the first quarter did not appear to have resulted in overall stock imbalances as evidenced by stock–sales ratios or anecdotal reports. Even so, growth in inventory investment at a pace sharply exceeding the sustainable growth of final sales was unlikely to continue for an extended period. Given the ample availability of industrial capacity and the related absence of pressures on lead or delivery times, business firms did not need to build precautionary stocks. Thus, inventory investment was likely to respond to the expected deceleration in final sales over coming quarters. Some members expressed reservations about the probable extent of the deceleration in the period ahead, especially in the context of their expectations of a still relatively robust uptrend in final sales.

Developments in Asia clearly were having adverse effects on a number of U.S. industries, but the overall effects on the U.S. economy appeared to have been limited thus far. Indeed, the direct effects of the Asian financial and economic problems on U.S. trade over time needed to be weighed against their indirect but positive effects in the near term in helping to hold down U.S. interest rates and in reducing the prices of oil and other imported commodities. However, members were concerned that, as evidenced by the most recent developments, conditions in Asian financial markets and economies were deteriorating further, with potentially adverse consequences for net U.S. exports. Of particular concern in this regard was the possibility of worsening economic conditions in Japan and the negative implications not only for U.S. trade with Japan but for worldwide trade and financial markets. Some members also commented that unsettled financial and economic conditions in East Asia could tend to exacerbate the economic problems of several important emerging economies in other parts of the world, including major Latin American trading partners of the United States. On balance, forecasts of a limited further drag on U.S. net exports from developments in Asia were subject to substantial uncertainty, with the risks tilted toward a greater effect on the U.S. economy than had been anticipated earlier. Moreover, the lingering effects of the dollar's appreciation last year against a broad array of currencies would continue to depress the nation's foreign trade position for some time.

The decline in the unemployment rate to its lowest level in nearly three decades underscored anecdotal reports of further tightening in labor markets in recent months and added to concerns about the outlook for inflation. Though the first-quarter data had not suggested as steep an increase as a number of observers had anticipated, labor compensation clearly was trending higher. But as suggested by the rise until recently in profit margins, businesses had been able to realize productivity gains that tended to offset the faster increases in compensation costs. Indeed, while the most recent data were difficult to read, once likely revisions were taken into account productivity improvements could well be on a steeper uptrend than had been estimated earlier. Even so, the members remained concerned that if pressures on labor resources continued to intensify, the associated increases in labor compensation would at some point significantly exceed the gains in productivity. The resulting pressures on prices might be muted, but probably only for a time, by the inability of many business firms in highly competitive markets to raise their prices or to raise them sufficiently to offset rising costs. Some members emphasized that a number of developments that had held down prices, including the dollar's sizable appreciation last year, the drop in world oil prices, and the downtrend in employee benefit cost increases, were unlikely to be repeated over the coming year and could even be reversed to a degree. Members acknowledged, however, that the nexus between labor market tightness, accelerating labor costs, and the effects on price inflation was very difficult to ascertain and analyses based on earlier patterns that pointed to rising inflation had proved consistently wrong in recent years.

In the Committee's discussion of monetary policy for the intermeeting period ahead, a majority of the members indicated that they preferred or could accept an unchanged policy. These members also expressed a preference for retaining the asymmetric instruction in the directive that the Committee had adopted at the previous meeting. In this view, the uncertainties in the outlook for economic expansion and inflation remained sufficiently great to warrant a continued wait-and-see policy stance. Considerations underlying this view included the possibility that financial and economic conditions in Asia might worsen further and exert a stronger retarding effect on the performance of the U.S. economy than presently seemed to be in train. A good deal of uncertainty also surrounded the potential extent to which developments in the domestic economy, notably the pace of inventory accumulation over coming months, might foster slower economic expansion and the related degree to which pressures in labor markets would be affected. Moreover, considerable questions remained about the relationship of labor market pressures to inflation. In these circumstances, it was possible that inflation would continue to be contained, though the risks clearly seemed to be tilted in the direction that action would become necessary at some point to keep inflation low.

While a delay in implementing a tighter policy that ultimately proved to be needed to curb rising inflation involved some risks, many of the members concurred in the view that the potential costs of postponing action for a limited time were small. By some measures, inflation had continued to drop in the first quarter, and the appreciation of the dollar, reduced commodity prices, and low—if not declining—inflation expectations would help to hold down nominal wage increases and price pressures for some time, even if, as a number of members suspected, the economy was now producing beyond its long-run potential. Forecasts of rising inflation had proved unreliable and needed to be viewed in light of the considerable uncertainties surrounding them. The members recognized, however, that the longer any needed action was delayed, the more important it would be to take prompt and perhaps vigorous action once the danger of rising inflation became clearer.

Another reason for not taking action at this meeting was the possibility that even a modest tightening action could have outsized effects on the already very sensitive financial markets in Asia. The resulting unsettlement could have substantial adverse repercussions on U.S. financial markets and, over time, on the

U.S. economy. Many of the members emphasized, however, that market considerations could not be allowed to jeopardize the effective conduct of a U.S. monetary policy aimed at an optimal performance of the U.S. economy. Indeed, such a performance would best serve the interests of troubled financial markets and economies abroad.

A number of members indicated that the decision was a close call for them. In this regard, some emphasized that financial conditions were very accommodative in terms of the ample availability of financing to most borrowers on very attractive terms and increases in equity prices. Several expressed concern that the persistence of quite rapid monetary growth this year was symptomatic of a monetary policy that was not positioned to restrain ebullient domestic demand sufficiently, even if short-term real interest rates were quite high. Although some of these members could accept postponing action for the present to await further information on the balance of risks, two members, while acknowledging the uncertainties that surrounded the economic outlook, indicated a strong preference for tightening the stance of policy at this meeting. They believed that current policy was accommodating excessive strength in aggregate demand that very likely would be felt in higher inflation before long. Prompt tightening was needed to avert the necessity of stronger and potentially disruptive policy actions later to contain inflation.

All the members who intended to vote for an unchanged policy at this meeting supported the retention of a directive that was biased toward restraint. In their view, current developments did not call for any policy action, at least at this meeting, but because they felt the risks were tilted in the direction of rising inflation, a policy tightening move, possibly in the near future, was a likely though not an inevitable prospect.

At the conclusion of the Committee's discussion, all but two of the members supported a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that contained a bias toward the possible firming of reserve conditions and a higher federal funds rate. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with considerable moderation in the growth of M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that economic activity has continued to grow rapidly in 1998. Nonfarm payroll employment registered another substantial increase in April after a slight decline in March, and the civilian unemployment rate fell to 4.3 percent in April. However, factory output has changed little on balance in recent months. Retail sales grew appreciably in April, and consumer spending as a whole has been very strong this year. Residential sales and construction also have strengthened this year. Business fixed investment rebounded sharply in the first quarter after having declined slightly in the fourth quarter, and available indicators point to continuing strength over coming months. Business inventories appear to have increased very rapidly in the first quarter. The nominal deficit on U.S. trade in goods and services widened substantially in January and February from its average monthly rate in the fourth quarter. Despite indications of persisting pressures on employment costs associated with tight labor markets, price inflation has remained subdued this year, primarily as a consequence of large declines in energy prices.

Most market interest rates have declined slightly on balance over the intermeeting period. Share prices in U.S. equity markets have moved up a little further. In foreign exchange markets, the trade-weighted value of the dollar in terms of major currencies has changed little on net over the period. However, the dollar has risen on balance against the currencies of key emerging market economies, particularly those in Asia. Equity markets in Asia have fallen substantially over the period to near their lows of late 1997, while those in Europe have risen to new highs.

M2 and M3 expanded briskly further in April, but data for late April and early May show M2 declining and M3 leveling out. The swing in these measures seemed to be related largely to movements of funds associated with tax payments. Expansion of total domestic nonfinancial debt appears to have moderated somewhat after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic non-financial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with considerable moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Mses. Minehan, Phillips, and Rivlin. Votes against this action: Messrs. Jordan and Poole.

Mr. Poole dissented because he believed that the sustained increase in money growth in recent quarters and associated accommodative conditions in the credit markets pointed to rising inflation. Although faster productivity growth suggested that trend output growth might be modestly higher than previously thought, the growth rate of aggregate demand over the past two years clearly had exceeded the economy's long-run growth potential. Without a reduction of aggregate demand growth, inflation would rise. In his view, the Federal Reserve should therefore take prompt action to reduce money growth to limit the rise in inflation and to avoid an increase in longer-term inflation expectations, which would tend to destabilize aggregate employment and financial markets.

Mr. Jordan also noted that the monetary and credit aggregates had accelerated further from already rapid growth rates in 1997. In his view, these high growth rates were fueling unsustainably rapid increases of real estate and other asset prices, and reports of "too much cash chasing too few deals" were becoming more frequent. Anticipated gains on both real and financial investments had risen relative to the cost of borrowed funds. In these circumstances, it was increasingly likely that the Committee would face a choice between smaller increases in interest rates sooner versus larger increases later. He added that maximum sustainable economic growth occurs when businesses and households act on the assumption that the dollar will maintain its value over time, and nothing he had heard from consumer groups, bankers, or other business people in his District led him to believe that decisions were being made in the expectation that the purchasing power of the dollar would be stable. Furthermore, expectations that market values of income-producing investments would continuously rise relative to underlying earning streams were not consistent with a stable purchasing power of money. He also believed that the view that real interest rates currently were high was not confirmed by observed behavior. Bankers told him that both consumers and businesses believed that credit was cheap and plentiful. These potentially inflationary conditions and imbalances in the economy were not conducive to sustained maximum growth.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 30–July 1, 1998.

The meeting adjourned at 1:35 p.m.

Donald L. Kohn
Secretary

Meeting Held on June 30–July 1, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, June 30, 1998, at 1:30 p.m. and continued on Wednesday, July 1, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Ms. Browne, Messrs. Dewald, Hakkio, Lindsey, Simpson, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

Messrs. Small,[3] Reifschneider,[3] and Whitesell, Section Chiefs, Divisions of Monetary Affairs, Research and Statistics, and Monetary Affairs respectively, Board of Governors

Ms. Kusko,[4] Senior Economist, Division of Research and Statistics, Board of Governors

Mr. Elmendorf[4] and Ms. Garrett, Economists, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lang, Rosenblum, and Steindel, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Chicago, Philadelphia, Dallas, and New York respectively

Ms. Perelmuter, Vice President, Federal Reserve Bank of New York

Mr. Bryan, Assistant Vice President, Federal Reserve Bank of Cleveland

3. Attended portion of the meeting relating to the discussion of the Committee's consideration of its monetary and debt ranges for 1998 and 1999.

4. Attended portions of the meeting relating to the Committee's review of the economic outlook and consideration of its monetary and debt ranges for 1998 and 1999.

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 19, 1998, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets and on System transactions in those markets during the period May 19, 1998, through June 30, 1998. By unanimous vote, the Committee ratified these transactions.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period May 19, 1998, through June 30, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook, the ranges for the growth of money and debt in 1998 and 1999, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the expansion in economic activity had slowed considerably after a very rapid advance in the first quarter. Much of the slowdown reflected a substantial moderation in business inventory accumulation. Consumer spending, business investment, and residential homebuilding, though remaining robust, apparently also were decelerating somewhat after very strong gains in the first quarter; and the erosion in net exports continued to damp demand for domestically produced goods. Payroll employment persisted on a brisk uptrend, but industrial production seemed likely to record only modest further expansion in the second quarter. Labor markets remained tight, and there were indications of some further acceleration in employment costs. Recent data on consumer prices were a little less favorable than they had been earlier in the year.

Nonfarm payroll employment registered substantial increases in April and May despite further job losses in manufacturing. Construction payrolls declined in May, but they were up sharply on balance over the April–May period following substantial gains earlier in the year. Employment increases in service-producing industries, notably business services and retail and wholesale trade, continued to be robust. The civilian unemployment rate stayed at 4.3 percent in May, and initial claims for unemployment insurance remained low through mid-June, after taking into account the onset of layoffs associated with the strike at General Motors.

Industrial production picked up in April and May after having changed little in the first quarter, but the strike at General Motors likely depressed industrial production substantially in June. In manufacturing, the output of motor vehicles rose briskly on balance over April and May, and the production of computers and office equipment remained robust. Growth in the manufacture of materials slowed sharply, perhaps reflecting the effects of reduced exports to Asia. Output of utilities, which continued to fluctuate widely, changed little on balance over the April–May period. The rate of utilization of manufacturing capacity edged down in May to its lowest level in more than two years as capacity grew at a faster rate than output.

Total nominal retail sales posted large gains in April and May. Sales were strong at automotive dealers in response to a sharp increase in incentives offered by the Big Three automakers. Sales also rose briskly at building material and supply outlets and at general merchandise, apparel, and furniture and appliance stores. Although the growth in real outlays for services in April (latest data available) was held down by a small decline in purchases of energy services, the expansion of outlays for non-energy services remained brisk. Sales of homes were very strong in April and May, but housing starts and building permits declined slightly on a seasonally adjusted basis from their elevated first-quarter rates.

Available information suggested that the growth of business fixed investment slowed somewhat in the second quarter from a very strong pace earlier in the year. A deceleration in expenditures for producers' durable equipment, after the surge in purchases of computer and communications equipment in the first quarter, apparently more than offset a pickup in spending on nonresidential structures. The recent upturn in building activity was consistent with the continuing indications of declining vacancy rates and rising real estate prices, but available data on construction contracts did not point to further strength in nonresidential construction.

Business inventory investment slowed sharply in April from the extraordinarily rapid rate of accumulation in the first quarter. In manufacturing, stockbuilding picked up somewhat in April from the first-quarter pace, but with sales also rising, the stock–sales ratio remained at a very low level. Wholesale inventories declined sharply in April, primarily reflecting runoffs in stocks of motor vehicles; the inventory–sales ratio for the sector remained near the upper end of its range over the preceding twelve months. Retail inventory accumulation slowed somewhat in April, and the aggregate inventory–sales ratio stayed close to the lower end of its range over the past year.

The nominal deficit on U.S. trade in goods and services widened further in April, as the value of exports declined more than that of imports. Exports of aircraft and parts dropped sharply from the first-quarter level, and exports of industrial supplies decreased by lesser amounts. Most of the decline in imports was in capital goods and automotive products. Recent information suggested a mixed economic performance among the major foreign industrial countries. Economic activity in Japan contracted sharply in the first quarter after having declined slightly in the fourth quarter, and many other economies in Asia remained quite weak. The Asian crises held down exports of the major European countries, partly offsetting the influence of strong domestic demand.

Consumer prices advanced at a slightly faster rate in May as an upturn in energy prices and a large increase in food prices more than offset a slower rate of increase in the prices of nonfood, non-energy items. Core consumer prices accelerated during the three months ended in May, largely reflecting higher tobacco prices and shelter costs. Nonetheless, core consumer prices rose less over the twelve months ended in May than they had over the previous twelve months. At the producer level, prices of finished goods other than food and energy continued to rise at a subdued rate in May. For the twelve months ended in May, core producer prices rose by a small amount after having changed little in the year-earlier period. At the intermediate level, core producer prices edged down in May and were little changed on net over the twelve months ended in May. Average hourly earnings of production or nonsupervisory workers increased at a slightly faster rate on balance over April and May. Measured on a year-over-year basis, average hourly earnings accelerated further in the year ended in May. The largest gains were in business services and finance, insurance, and real estate, but marked acceleration also was evident in wholesale and retail trade. By contrast, gains in manufacturing had changed little over the past three years.

At its meeting on May 19, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that would be consistent with the federal funds rate continuing to average around 5½ percent. In light of concerns that growth in aggregate demand might remain so strong relative to the expansion of the economy's potential that inflationary pressures would tend to be generated, the Committee chose to retain an asymmetric directive tilted toward a possible firming of reserve conditions and a higher federal funds rate. The reserve conditions associated with this directive were expected to be consistent with considerable moderation in the growth of M2 and M3 over the months ahead.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate averaged close to the intended level of 5½ percent. Market participants interpreted the further turmoil in financial markets in Asia and emerging market economies elsewhere as damping the outlook for U.S. economic growth and improving the chances that inflation would remain low. While most short-term interest rates changed little on balance over the period, yields on longer-term Treasury securities, and to a lesser extent on private debt instruments, declined somewhat, at least partly reflecting a further flight to safety and quality from renewed turbulence in a number of foreign markets. Share prices in U.S. equity markets remained volatile, and changes in major indexes were mixed on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of other major currencies continued to increase through the middle of June, but it then retraced much of that rise, ending the intermeeting period somewhat higher on balance. The recent fluctuations in the dollar's trade-weighted value were largely accounted for by movements in the Japanese yen, which reached an eight-year low against the dollar in the middle of June in response to growing market pessimism about the prospects for a prompt resolution of Japan's financial sector problems and for economic recovery in that country. The yen rebounded in mid-June in response to coordinated intervention by the Japanese and U.S. governments but soon renewed its downward drift, partly as a result of rising concerns that the Japanese government would not take prompt action to address weaknesses in the country's banking sector and in aggregate demand; the yen finished the period substantially lower on balance. The dollar changed little on net against the German mark and other continental European currencies; declines in long-term interest rates in those countries generally matched the drop in yields on comparable U.S. instruments. Against the backdrop of weakness in the yen, the currencies of key emerging market economies, particularly some of those in Asia, fell further against the dollar.

Growth of M2 and M3 slowed in the second quarter but remained fairly robust. Households accumulated unusually large deposit balances to make hefty nonwithheld tax payments in April, and these balances ran off in May as tax checks cleared; averaging through these gyrations, the expansion of the broad aggregates slowed on balance over April and May, and preliminary data suggested further slowing in June. The growth of M3 remained a little faster than that of M2, reflecting the further progress made by institution-only money market funds in attracting corporate cash-management business. For the year through June, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appeared to have moderated somewhat after picking up earlier in the year; the moderation evidently reflected some slowing in the growth of business and household borrowing as well as paydowns of federal debt made possible by robust tax revenues.

The staff forecast prepared for this meeting indicated that economic activity would expand more slowly over the projection period than it had in recent years. Moderation in business inventory investment would damp domestic production as inventory accumulation was brought into better balance with the expected more moderate trajectory of final sales. In addition, reduced growth of foreign economic activity and the lagged effects of the sizable earlier rise in the foreign exchange value of the dollar were anticipated to place substantial restraint on the demand for U.S. exports and to lead to further substitution of imports for domestic products. The staff analysis suggested that the prospective gains in income coupled with the run-up that had occurred in household wealth would support further brisk, though gradually diminishing, increases in consumer spending. Housing demand was expected to remain at a generally high level in the context of the persisting favorable cash flow affordability of home ownership, though the slower income growth anticipated over the projection period would damp homebuilding somewhat. Growth in business fixed investment would gradually moderate from the vigorous pace of the first half of the year in response to smaller increases in business sales and profits. Pressures on labor resources were likely to diminish somewhat as the expansion of economic activity slowed, but underlying inflation was expected to pick up gradually as gains in compensation increasingly outpaced improvements in productivity.

In the Committee's discussion of current and prospective economic developments, the members generally agreed that the expansion in economic activity was likely to be relatively moderate over coming quarters, and that such growth would be consistent with some limited increase in inflation from the current unusually low level. The accumulation of business inventories, which until recently had added substantially to economic growth, was expected to continue at a much lower and more sustainable pace. Moreover, the effects on the U.S. trade balance of the appreciated value of the dollar and of economic weakness in several of the nation's trading partners probably would hold down increases in domestic output in coming quarters. Many of the members commented, however, that the already substantial risks surrounding the economic outlook had increased on both sides of their forecasts. On the downside, the greater risks focused on potential developments in Asia. Financial and economic conditions in Asia had deteriorated in recent months, and the members could not rule out the possible emergence of even greater financial turmoil and economic weakness in that part of the world that could spill over to other countries, including the United States. On the upside, in the absence of strongly retarding effects from developments in Asia, persistent strength in domestic final demand might well add to inflationary pressures. Indeed, there were signs of modestly rising inflation in some recent measures of prices, though the rate of inflation was still relatively subdued.

In keeping with the practice at meetings when the Committee sets its long-run ranges for the money and debt aggregates, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the years 1998 and 1999. The forecasts of the rate of expansion in real GDP for 1998 as a whole had a central tendency of 3 to 3¼ percent, which implied some moderation over the second half from staff estimates at the time of this meeting of the average rate of growth in the first and second quarters; for 1999 the forecasts pointed to moderate growth and were centered on a range of 2 to 2½ percent. These projected rates of economic growth were accompanied by a very slight rise in the civilian rate of unemployment over the next eighteen months to still quite low rates centering on 4½ to 4¾ percent in the fourth quarter of 1999. With regard to the growth of nominal GDP, most of the forecasts were in ranges of 4½ to 5 percent for 1998 and 4¼ to 5 percent for 1999. Projections of the rate of inflation, as measured by the consumer price index, indicated a slightly faster rise over the second half of this year and in 1999, largely because of expectations that the plunge in energy prices earlier in the year would not be repeated. Specifically, the projections converged on

CPI inflation rates of 1¾ to 2 percent for 1998 as a whole and 2 to 2½ per cent in 1999.

In their review of developments in different parts of the country, Reserve Bank presidents reported high levels of business activity across the nation, but several also indicated that there were signs of some slowing in the expansion of regional economic activity. With regard to the nation as a whole, members noted that rising levels of employment and incomes were continuing to foster solid growth in consumer spending, a development that was abetted by the sharp increases that had occurred in household wealth as a consequence of the extended uptrend in stock market prices and to a lesser extent the appreciation of home prices. However, some anecdotal and other evidence suggested that retail sales had moderated in recent weeks in at least some areas; the moderation appeared to be only partly associated with the work stoppage at General Motors. The apparent deceleration in retail sales could prove to be temporary, though some slowing in the growth of overall consumer spending over the forecast horizon, perhaps to a pace more in line with the growth of disposable income, was viewed as a reasonable expectation, especially with equity price gains of recent years unlikely to be repeated.

Business fixed investment remained on a strong uptrend, buoyed by several favorable factors. The latter included the ready availability of debt and equity financing on relatively attractive terms, and opportunities to invest in high-tech equipment at lower prices to enhance productivity and hold down labor costs in a period of very tight labor markets. While these factors were expected to support appreciable further expansion in business investment, growth in demand for capital goods was likely to diminish as a result of the projected slowing in the expansion of final sales and business profits and the absence of pressure on manufacturing capacity. With regard to the outlook for nonresidential construction, members reported that declining vacancy rates and rising prices and rents of office buildings and to some extent other commercial structures were fostering very high levels of construction activity in several areas. Moreover, there were indications that some construction projects were being delayed because of scarcities of labor or construction materials. A number of members commented that some of the construction was being undertaken on a speculative basis and that the strong pace of building activity pointed to overbuilding in some areas. On the residential side, construction activity also displayed considerable strength across much of the country. There were widespread anecdotal and other reports of high levels of home sales and few reports of faltering housing demand. Favorable factors undergirding current housing activity, including the robust growth in employment and incomes, high wealth-to-income ratios, and very attractive terms on home mortgages, seemed likely to continue to hold housing construction close to current elevated levels.

Based on very partial data, business inventory investment appeared to have moderated considerably in the second quarter from an unsustainable pace in the first quarter, and some further reductions in inventory accumulation could be expected over the balance of the year. Several members commented, however, that despite the outsized rate of stockbuilding early in the year, there were no broad indications of an inventory overhang, whether from the standpoint of inventory–sales ratios or anecdotal expressions of concern. Against this background, many of the members saw little reason to anticipate a further sizable drop in nonfarm inventory investment, though the performance of this sector of the economy was always subject to a high degree of uncertainty.

With regard to the external sector of the economy, the recent deterioration of conditions in Japan and several emerging economies in Asia and the related effects on other countries around the world were adding significantly to the uncertainties facing the U.S. economy. Members commented that it was too soon to judge the eventual extent and duration of the turmoil in Asia and its spillover to other nations, but several suggested that the consequences were likely to be more severe and longer lasting than they had anticipated earlier. Moreover, there seemed to be a very small but growing possibility of marked and spreading weakness that might have a more major effect on U.S. financial markets and the U.S. economy. One key to an improvement in the outlook for Asia was the adoption of appropriate policies by Japan, but very difficult political as well as economic problems clearly were involved for that nation and their resolution might well require an extended period of internal deliberations. From the standpoint of the United States, the Asian crisis and its repercussions around the world obviously were deepening the nation's trade deficit, but other effects such as those on U.S. interest rates and prices in world commodity markets, notably oil, were boosting domestic demand and tended to have a moderating near-term influence on inflation.

With regard to the outlook for prices and wages, members observed that some key measures of price inflation had displayed a modest uptilt recently. Though overall price inflation had remained subdued when viewed over a longer horizon, signs of a continuing acceleration, should they become evident, would be a matter of growing concern. Reflecting very tight labor markets, the rate of increase in labor compensation had been on an uptrend, but the rise in unit labor costs and overall unit product costs had been held down to a very modest pace by gains in productivity. At some point, however the advance in labor compensation would exceed likely improvements in productivity by an increasing margin unless the expansion in overall demand, and hence in labor demand, moderated significantly. Members cited greater, albeit still occasional, indications of heightened worker demands in labor negotiations that likely were encouraged in part by ample job opportunities. Any tendency for faster increases in labor costs to feed through to price inflation was likely to be reinforced for a time by the unwinding of a number of special factors that had tended to hold inflation down, including the decline in energy prices in recent quarters and the dollar's appreciation during 1997. Moreover, a rise in inflation would tend to erode currently favorable inflation expectations and lead workers to demand higher nominal compensation. Nonetheless, questions could be raised about how rapidly and to what extent the effects of tight labor markets would show through to higher labor compensation and overall producer costs and in turn how quickly the latter would induce significantly faster increases in prices. Very competitive domestic and international markets for a wide range of products along with reduced prices of oil, other commodities, and imports more generally could well keep inflation in check for some time. It was noted in this regard that members had tended in recent years to anticipate greater inflation than had materialized.

In keeping with the requirements of the Full Employment and Balanced

Growth Act of 1978 (the Humphrey–Hawkins Act), the Committee at this meeting reviewed the ranges for growth of the monetary and debt aggregates that it had established in February for 1998 and also decided on tentative ranges for those aggregates in 1999. The current ranges for the period from the fourth quarter of 1997 to the fourth quarter of 1998 were unchanged from the ranges for other recent years and included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3. An unchanged range of 3 to 7 percent also was set in February for growth of total domestic nonfinancial debt in 1998.

All the members favored or could support the retention of the current ranges for this year and their extension on a provisional basis to 1999. They took note of a staff projection that indicated that, given the Committee's expectations for the performance of the economy and prices and assuming no major changes in interest rates, growth of M2 and M3 probably would exceed the current ranges in 1998 and decline to a little below the upper end of those ranges in 1999. Both M2 and M3 had grown unusually quickly relative to spending in the first half of the year. The staff analysis suggested that some of the forces that might have been responsible for this decline in velocity would abate, and the projections anticipated that the velocity of M2 would be roughly in line with historical experience before the early 1990s, as it had been, on balance, for several years.

In their discussion of the choice of ranges for growth of M2 and M3 in 1998 and 1999, the members agreed that those ranges should not reflect forecasts of money growth under anticipated economic and financial conditions, but instead should be viewed as anchors or benchmarks for money growth that would be associated with price stability and sustained economic growth, assuming behavior of velocity in line with historical experience. Reaffirming the current ranges for 1998 and extending them to 1999 would thus underscore the Committee's commitment to a policy of achieving price stability over time. In the view of a few members, the Committee should consider adopting ranges centered on its expectations for growth of the monetary aggregates in the future, but only if the members became more confident about the relationship between the growth of money and measures of aggregate economic performance and undertook to give more weight to the growth of the broad monetary aggregates in setting monetary policy. Some members noted that retention of the current monetary ranges oriented toward price stability did not preclude greater use of the aggregates in assessing overall financial conditions and the formulation of monetary policy. The Committee agreed that the current range for nonfinancial debt for 1998 should be left unchanged and that the same range should be extended to 1999. The current range readily encompassed the growth rate seen likely to be associated with the members' forecasts for economic activity and prices.

At the conclusion of this discussion, the Committee voted to reaffirm the ranges for growth of M2, M3, and total domestic nonfinancial debt that it had established in February for 1998 and to extend those ranges on a tentative basis to 1999. In keeping with its usual procedure under the Humphrey–Hawkins Act, the Committee would review its preliminary ranges for 1999 early next year. Accordingly, the Committee voted to incorporate the following statement regarding the 1998 and 1999 ranges in its domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at this meeting the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1998 to the fourth quarter of 1999, of 1 to 5 percent for M2 and 2 to 6 percent for M3. The Committee provisionally set the associated range for growth of total domestic nonfinancial debt at 3 to 7 percent for 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Votes against this action: None.

In the Committee's discussion of policy for the intermeeting period ahead, all but one of the members indicated that they could support an unchanged policy stance and retention of the current tilt toward possible tightening in the directive. Although recent developments had increased both the upside and the downside uncertainties in the economic outlook, most of the members felt that the risks continued to point on balance toward rising inflation. While the available evidence suggested that the economic expansion had in fact slowed considerably in the second quarter, largely because of reduced inventory accumulation against the backdrop of weakness in the foreign trade sector, the retarding effects of those factors were seen as likely to wane over coming quarters and there were only limited indications of any softening in domestic final demand. Moreover, the persistence of accommodative financial conditions, as evidenced by the ample availability of financing on favorable terms to business and household borrowers and by robust monetary growth, might well continue to support relatively strong domestic spending. As a consequence, many of the members expressed concern that the expansion in demand might continue at a fast enough pace to raise pressures on wages and prices over time. Nonetheless, the substantial uncertainties relating to prospective developments argued, as they had at recent meetings, in favor of a cautious "wait and see" policy stance.

Another important reason for deferring any policy action was that a tightening move would involve the risk of outsized reactions and consequent destabilizing effects on financial markets in the growing number of countries abroad that were experiencing severe financial difficulties. It was not possible to anticipate precisely what those effects might be, but the risks seemed to be particularly high at this time. To be sure, U.S. monetary policy had to be set ultimately on the basis of the needs of the U.S. economy, but recognition had to be given to the feedback of developments abroad on the domestic economy. Those repercussions could be quite severe in the event of further sizable economic and financial disturbances in some of the nation's important trading partners. Many members concluded that because there did not seem to be any urgency to tighten current policy for domestic reasons, given the likelihood that inflation would remain subdued for a while, important weight should be given to potential reactions abroad. A number of these members emphasized, however, that they continued to see a high probability that some tightening of monetary policy would be needed later to curb rising inflationary pressures. Accordingly, they believed that the Committee should take advantage of any early opportunity to tighten policy in order to improve the prospects of containing inflation and prolonging the economic expansion. One member was persuaded, however, that such a policy move should be implemented at this meeting in order to avert the need for a stronger and probably more disruptive policy adjustment that would be needed later to head off rising inflation.

Given that the balance of risks was seen as pointing to rising inflation over time, the members agreed that it was desirable to retain the tilt toward restraint in the directive. Such a tilt would continue to underscore the Committee's commitment to its long-run objective of price stability and its view of the likely direction of the next policy move.

At the conclusion of the Committee's discussion, all but one of the members accepted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that contained a bias toward the possible firming of reserve conditions and a higher federal funds rate. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth in M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that the expansion in economic activity has slowed considerably after a very rapid advance in the first quarter. Nonfarm payroll employment registered another substantial increase in May, and the civilian unemployment rate was unchanged at 4.3 percent. Industrial output picked up in recent months after weakening early this year; however, a strike at General Motors likely depressed output substantially in June. Although retail sales posted large gains in April and May, overall consumer spending appears to have grown less rapidly in the second quarter than in the first. Residential sales have remained exceptionally strong, but housing starts and building permits slipped back in the spring, on a seasonally adjusted basis, from a sharply increased first-quarter level. Available indicators suggest that growth of business fixed investment also is slowing after a surge earlier in the year. Business inventory accumulation appears to have moderated in April from an extraordinarily rapid rate in the first quarter. The nominal deficit on U.S. trade in goods and services continued to widen in April. Developments in the food and energy sectors contributed to a slightly faster advance in consumer prices in May.

Most short-term interest rates have changed little since the meeting on May 19, but longer-term rates have declined somewhat. Share prices in U.S. equity markets remained volatile and changes in major indexes were mixed on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar rose sharply through mid-June in terms of other major currencies, declined more recently, but is up somewhat on net since the May meeting; the fluctuations in the average value of the dollar in terms of these major currencies were largely related to movements against the Japanese yen. The dollar has risen further against the currencies of key emerging market economies, particularly some of those in Asia.

Growth of M2 and M3 slowed in the second quarter, but remained fairly robust. For the year through June, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appears to have moderated somewhat after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at this meeting the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1998 to the fourth quarter of 1999, of 1 to 5 percent for M2 and 2 to 6 percent for M3. The Committee provisionally set the associated range for growth of total domestic nonfinancial debt at 3 to 7 percent for 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Votes against this action: Mr. Jordan.

Mr. Jordan dissented because he believed that the unsustainably rapid growth of domestic demand—fueled by the acceleration of money and credit growth in the past year—was reflected in the recent sharp increase in imports and rising trade deficits. As U.S. output growth slows significantly from the rapid pace of 1997 and early 1998, it will be essential that domestic demand also slow. The very welcome progress toward eliminating inflation in recent years has contributed to the outstanding performance of the economy. Allowing domestic demand to continue to exceed domestic production would run the risk that corrosive effects of rising inflation would undermine future growth prospects. Furthermore, the resultant trade and current account deficits would have to be matched by ever larger inflows of foreign capital. Modest monetary restraint at this time might prevent either the buildup of inflationary imbalances that would eventually necessitate future policy restraint or unsustainable capital flows. In either case an economic contraction might become unavoidable.

The meeting adjourned at 12:40 p.m.

Donald L. Kohn
Secretary

Meeting Held on August 18, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 18, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Guynn and Parry, Presidents of the Federal Reserve Banks of Atlanta and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Hooper and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Struckmeyer, Assistant Director, Division of Research and Statistics, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Strand and Mr. Varvel, First Vice Presidents, Federal Reserve Banks of Minneapolis and Richmond respectively

Messrs. Beebe, Goodfriend, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, and Dallas respectively

Messrs. Bolwell, King, Kopcke, Meyer, and Sullivan, Vice Presidents, Federal Reserve Banks of New York, Atlanta, Boston, Philadelphia, and Chicago respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 30–July 1, 1998, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets during the period since the previous meeting. There were no open market operations in foreign currencies for the System's account during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period July 1, 1998, through August 17, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that domestic final demand continued to expand at a robust pace. However, increases in consumer spending and business investment seemed to be moderating somewhat after very large gains earlier in the year, and inventory investment had slowed markedly. Net exports remained weak as a result of the persisting turmoil in Asian economies. The strike at General Motors had damped overall economic activity temporarily, but total payroll employment continued to trend upward, and labor markets remained extremely tight. Despite the pressures on labor resources, trends in wages and prices had remained stable in recent months.

Nonfarm payroll employment expanded further in July even though manufacturing payrolls plunged in association with the General Motors strike; job growth remained strong in most nonmanufacturing sectors. Construction employment continued to increase at about the brisk pace recorded over the first half of the year, and hiring in retail trade surged. The expansion of jobs in the services industry slowed considerably in July, but this partly reflected a decline in temporary help jobs related to the GM strike. The civilian unemployment rate was unchanged in July at 4.5 percent.

Industrial production declined considerably in June and July. Abstracting from the effects of the GM strike, manufacturing output fell slightly over the June–July period after having recorded moderate gains on average in earlier months of the year; production of business equipment expanded briskly in June and July, while the output of consumer goods and materials weakened. The rate of utilization of manufacturing capacity was down appreciably in June and July, mostly reflecting the effects of the GM strike.

Total nominal retail sales fell in July after having risen at a rapid pace in the first half of the year. A sharp contraction in spending for motor vehicles, reflecting the termination at midyear of sales incentives offered by the Big Three automakers and shrinking inventories at GM dealers, more than accounted for the drop in July. Non-auto-related outlays continued on a robust upward trend, with gains evident in all major categories. Sales increases were particularly large at furniture and appliance stores and apparel outlets. In the housing sector, both demand and construction activity remained strong. Starts of single-family units edged down in May but rebounded in June. Sales of new homes were at an all-time high in June, and sales of existing homes were only a little below the record level reached in March of this year. With sales robust, the inventory of unsold new homes remained low.

Growth of business fixed investment slowed in the second quarter as the pace of business spending for durable equipment moderated considerably from the exceptionally strong rate of earlier in the year. Nonetheless, outlays for computer and communications equipment continued to expand rapidly in the second quarter, and purchases of other capital goods rose briskly. Available information suggested that growth in business spending on capital goods likely would slow further in the months ahead. In contrast to the strength in equipment spending, expenditures on nonresidential building declined further in the second quarter, and available indicators pointed to a mixed outlook for this sector in coming months.

Business inventory investment slowed sharply in the second quarter, owing in substantial measure to a runoff of motor vehicle inventories at the wholesale and retail levels. In manufacturing, stockbuilding slowed somewhat in the second quarter, and the stock–shipments ratio at the end of the quarter remained close to the low level that had prevailed over the past year. Wholesale inventories changed little on balance in the second quarter as a sizable decline in motor vehicle stocks offset a buildup of non-auto durable goods; in June, the aggregate inventory–sales ratio for this sector was at the upper end of its narrow range for the past year. At the retail level, a drop in inventories of motor vehicles in the second quarter more than offset a small increase in stocks at non-auto retailers, and the aggregate inventory–sales ratio in June was a little below the lower end of its range for the past year.

The nominal deficit on U.S. trade in goods and services widened substantially further in the second quarter; the value of exports of goods and services declined for a second straight quarter, while the value of imports continued to rise, though at a somewhat reduced pace. Much of the decline in exports in the second quarter was in capital goods, but there also were noticeable decreases in most other major trade categories. The increase in imports was concentrated in imported consumer goods, aircraft, and steel. Economic activity in most of the major foreign industrial countries continued to expand, though at a slower rate, in the second quarter. In Japan, however, economic activity appeared to have contracted sharply further in the second quarter. In most other Asian economies, currencies and equity prices were under downward pressure, and in Russia, asset values plummeted in often disorderly markets. Risk spreads on dollar-denominated debt widened substantially, not only in Russia but for Latin American issuers as well.

Price and wage inflation had remained relatively stable in recent months. Both the overall CPI and the CPI excluding food and energy items rose slightly on balance in June and July; a small rise in food prices offset a noticeable decline in energy prices over the two-month period. For the twelve months ended in July, the core CPI registered a slightly smaller increase than it had in the year-earlier period, partly reflecting lower prices for new motor vehicles. Producer prices of finished goods changed little on balance in June and July; a sizable drop in the prices of energy products over the June–July period more than offset a modest rise in core producer prices. For the year ended in July, core producer prices rose somewhat more than in the year-earlier period, reflecting larger increases in the prices of finished consumer goods. Hourly compensation of private industry workers rose in the second quarter at about the average rate for the previous two quarters. For the year ended in June, however, hourly compensation picked up significantly from the year-earlier period; the acceleration in compensation was evident in wages and salaries and in benefits.

At its meeting on June 30–July 1, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that would be consistent with the federal funds rate continuing to average around 5½ percent. With the balance of risks still pointing to the possibility of rising inflation over time, the Committee chose to retain an asymmetric directive tilted toward a possible firming of reserve conditions and a higher federal funds rate. The reserve conditions associated with this directive were expected to be consistent with moderate growth in M2 and M3 over the months ahead.

Open market operations were directed throughout the period since the meeting on June 30–July 1 toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate averaged a little above the intended level of 5½ percent. Most other interest rates fell slightly on balance over the intermeeting period in response to market assessments that worsening conditions in Asia, Latin America, and Russia portended slower growth in U.S. output and inflation over an extended period ahead. Declines in Treasury yields also reflected a continuing flight toward safety and quality from the persisting turbulence in foreign markets. In an atmosphere of increasing concerns about the prospects for corporate earnings, share prices in U.S. equity markets remained volatile and major indexes declined appreciably on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar rose somewhat further over the intermeeting period in relation to other major currencies. The dollar changed little against the continental European currencies, but it moved up strongly against the Japanese yen and, to a lesser extent, the Canadian dollar. The dollar's rise in terms of the yen reflected spreading pessimism regarding the Japanese government's ability to redress the problems of its troubled banking system and provide fiscal stimulus adequate to turn its economy around. The dollar's advance against the Canadian dollar occurred in the context of continuing weakness in global commodity prices that was weighing down that currency. The dollar also appreciated slightly in terms of an index of the currencies of the developing countries of Latin America and Asia that are important trading partners of the United States.

After having expanded briskly in the second quarter, M2 grew at a somewhat more moderate rate in July, and M3 changed little. The deceleration in M2 reflected reduced inflows to retail money market funds. The halt in the growth of M3 was associated with a sharp runoff of large time deposits and outflows from institution-only money market funds triggered by a temporary spike in interest rates on market instruments around quarter-end. For the year through July, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appeared to have moderated somewhat in recent months after a pickup earlier in the year.

The staff forecast prepared for this meeting indicated that economic activity would expand through 1999 at a pace somewhat below the estimated growth of the economy's potential. Reduced growth of foreign economic activity and the lagged effects of the sizable earlier rise in the foreign exchange value of the dollar were anticipated to place substantial restraint on the demand for U.S. exports and to lead to further substitution of imports for domestic products. Moreover, additional moderation in business inventory investment would damp domestic production as inventory accumulation was brought into better balance with the forecast of a more moderate trajectory of final sales. The staff analysis suggested that the prospective gains in income coupled with the earlier run-up in household wealth would support further brisk, though gradually diminishing, gains in consumer spending. Housing demand was expected to remain relatively strong in the context of the persisting favorable cash flow affordability of home ownership, though the slower income growth anticipated over the projection period would damp homebuilding somewhat.

Growth in business fixed investment would gradually moderate from the vigorous pace of the first half of the year in response to smaller increases in business sales and profits. Pressures on labor resources were likely to diminish somewhat as the expansion of economic activity slowed, but inflation was expected to pick up gradually as a result of an anticipated reversal of some of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic conditions, members focused on the disparate forces that continued to shape trends in economic activity, notably the persistence of considerable strength in private domestic spending and the damping influences stemming from foreign economic developments. The latter seemed likely to be larger than previously anticipated as financial turmoil in some foreign economies had deepened and spread and currently showed few signs of stabilizing. Moreover, equity prices and risk spreads in U.S. financial markets were beginning to be adversely affected, potentially slowing domestic demand. The members generally anticipated somewhat more moderate growth than they had in their previous forecasts, with prospective expansion at a pace near or somewhat below the growth of the economy's potential. Nonetheless, they remained concerned about the potential for higher inflation, given the widespread tightness in labor markets and an upward tilt in the rise of labor compensation. For the present, however, inflation remained subdued, and it was likely to remain relatively low for some time in light of the weakness in commodity and other import prices and the tendency for low current inflation to hold down expected price increases.

Among the factors bearing on the outlook for domestic economic activity, the members viewed the external sector as a major source of uncertainty. The continued rapid decline in net exports during the first half of the year largely seemed to reflect the further financial unsettlement and a deeper contraction in Asian economies than had been anticipated earlier, and several members commented that they saw little evidence that financial and economic conditions in Asia were stabilizing. Indeed, such conditions appeared to be worsening further in some Asian nations, and other countries had been affected by the associated weakening in the demand for commodities and the more risk-averse attitudes of investors. Anecdotal reports at this meeting suggested that the impact on the domestic economy was being felt by manufacturing firms in several industries, although some firms also reported that declining exports to Asia were being offset at least in part by rising exports to other areas of the world. Looking ahead, the members agreed that the duration and extent of disruptions in Asian and other economies could not be anticipated with any degree of confidence; while net exports were not expected to decline as rapidly as they had in the first half of the year, even more serious disruptions in Asia could not be ruled out and would have important implications for the U.S. economy.

In their review of developments in key expenditure sectors of the domestic economy, members observed that over the first half of the year the strength in domestic final demand, notably in the consumer and business investment sectors, had more than offset the negative effects of developments in the foreign sector and other factors. In the consumer sector, the outlook for further sizable increases in spending was buttressed by unusually favorable underlying factors, including solid ongoing gains in employment and incomes and substantial further increases in household net worth this year. A pause in the robust gains in retail sales in early summer was accounted for in part by limited inventories of new motor vehicles associated with the now-settled GM strike. While a variety of factors pointed to sustained growth in consumer spending, a less ebullient stock market, should it persist, would foster more moderate expansion in consumer spending, perhaps at a pace more in line with the rise in consumer incomes, or at an even slower pace if consumer confidence were adversely affected by developments in financial markets.

Business fixed investment also seemed to be on a solid upward trajectory, though some slowing in the growth of business investment spending was anticipated in response to a projected deceleration in overall business output and weaker business profits. Members continued to cite anecdotal evidence of very strong construction activity in many parts of the country, including indications that building projects were being delayed because of shortages of labor and some construction materials. In other parts of the country, building activity remained at a high level but seemed to have moderated somewhat. Business spending for various types of high-tech equipment had surged to an undoubtedly unsustainable pace in the first half of the year. Against this background, several members referred to emerging signs of slightly more cautious attitudes among their business contacts, in many cases the result of concerns about developments in Asia. On balance, diminishing momentum in business investment appeared to be a likely prospect, but the ample availability of financing on favorable terms would continue to support this sector.

In the housing sector, construction activity remained at a high level in most parts of the nation and, as was the case for construction activity more generally, homebuilding continued to be restrained in a number of areas by limits on the availability of labor and other inputs. The housing market clearly was benefiting from strong gains in household incomes, high levels of household wealth, and very attractive financing costs. There were few indications of any moderation in this sector of the economy. Even so, some slowing was anticipated, at least after current construction backlogs were satisfied, in response to the projected slowing in employment growth and the high level of the housing stock.

Currently available data indicated that the pace of inventory accumulation had moderated substantially in the second quarter. Nonetheless, the rate of nonauto inventory investment in the spring still appeared to have exceeded a pace that was consistent with sustainable growth in sales. Anecdotal reports at this meeting pointed to a somewhat mixed picture with regard to desired inventory levels, including examples of both overstocking and shortages. Looking ahead and apart from short-run fluctuations, inventories were not expected to add to demand over coming quarters, at least after the restocking of motor vehicles by General Motors was completed.

In the Committee's discussion of the outlook for wages and prices, members commented that the rate of inflation in consumer prices was difficult to characterize with precision because alternative price indexes provided different measurement results; in particular, chain price indexes for consumption expenditures showed substantially less inflation than the CPI. Even so, it was clear on the basis of any measure that consumer prices and inflation more generally had remained remarkably subdued in the context of very tight labor markets and upward pressure on labor compensation. And whatever the explanation, it seemed that the economy had been less prone to rising inflation than it had been historically under similarly tight labor market conditions. The members acknowledged that a number of special factors were contributing to the relatively benign inflation climate. Those factors included the appreciation of the dollar; declines in many commodity prices, notably that of oil; ample industrial capacity; and evidently diminished inflation expectations. Moreover, substantial gains in productivity were muting the effects of rising labor compensation on unit costs, and vigorous competition in numerous markets was continuing to make it very difficult or impossible for business firms to raise their prices to cover rising costs or enhance profit margins. Against this backdrop, members remained persuaded that a significant rise in price inflation was not likely to occur in the nearer term.

Looking further ahead, however, the members generally agreed that rising price inflation remained an important threat. Significant additional tightening in labor markets would, of course, exacerbate that risk, but even at current levels these markets were tight and at some point labor costs could increase more rapidly, pressing on prices. Moreover, the effects of some of the factors holding down inflation seemed likely to wane, and possibly to reverse, over time. The latter included the effects of the dollar's appreciation on the prices of imports and competing domestic products, a possible upturn in energy prices and perhaps other commodity prices as foreign economies stabilized, and faster increases in the costs of worker benefits, notably those related to health care. The apparently greater willingness of labor unions to press for higher wages and other benefits in very tight labor markets might also intensify upward pressures on labor costs. On balance, while the risks of an overheating economy and rising price inflation might have faded to some degree, many of the members continued to emphasize that the Committee could not ignore those risks in its policy formulation.

In the Committee's discussion of policy for the intermeeting period ahead, all but one of the members agreed on the desirability of maintaining a steady policy stance. The overall performance of the economy remained highly satisfactory. While inflation risks were still a concern, given the high level of output and strong domestic demand, the uncertainties bearing on the economic outlook remained substantial, and indeed the risks on the downside seemed to have increased appreciably further. On balance, domestic economic and financial conditions had not changed sufficiently during the intermeeting period to warrant an adjustment to policy. With regard to the current uncertainties in the economic outlook, members emphasized that the extent and ultimate effects of the apparently spreading fragility in foreign financial markets and economies on U.S. financial and economic conditions were unknown. In these circumstances, nearly all the members believed that a cautious wait-and-see approach to policy seemed appropriate to allow the Committee time to assess the course of events and the interplay of the divergent forces bearing on the performance of the economy. In this regard it was noted that while domestic financial conditions remained generally accommodative, recent developments in foreign exchange and domestic financial markets had tended on balance to decrease some of the stimulative effects of financial conditions on aggregate demand in the United States by shifting demand overseas, increasing somewhat the cost of raising capital, and reducing the financial wealth of households. However, a few members expressed concern about the potentially inflationary implications of relatively rapid growth in key monetary aggregates over the past year, though such growth appeared to have moderated recently. And in the view of one of these members, the trend in monetary growth along with indications of rising speculative imbalances and excesses in various markets for financial and nonfinancial assets called for a prompt firming of monetary policy.

While overall economic conditions had not changed enough in recent weeks to warrant an adjustment in policy, a majority of the members agreed that the risks to the economic outlook were now more balanced and called for a shift from asymmetry to symmetry in the Committee's directive. Such a directive would better represent their view that the Committee's next policy move could be in either direction depending on developments abroad and their interaction with a domestic economy that had remained quite strong. Greater difficulties abroad and associated downward pressures on demand and prices had substantially diminished the chances of a strengthening of inflation pressures over coming months and quarters that would require a near-term tightening of policy. Other members continued to believe that the risks were still tilted to some degree toward rising inflation, though to a lesser extent than earlier. Labor market developments continued to suggest that the economy could well be producing beyond its sustainable potential and concrete signs that inflation pressures would abate had yet to emerge. Accordingly, they still preferred an asymmetrical directive but could accept symmetry in light of the prevailing uncertainties in the economic outlook and the expectation, shared by the other members, that policy would not need to be changed during the intermeeting period ahead.

At the conclusion of the Committee's discussion, all but one of the members were in favor of retaining a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent. Most also indicated that they could support a shift to a directive that did not include a presumption about the likely direction of any adjustments to policy during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that slightly greater or slightly lesser reserve restraint would be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth in M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that domestic final demand has continued to expand at a robust pace, but overall economic activity has been adversely affected by the strike at General Motors and developments in Asia. Nonfarm payroll employment continued to expand through July and the civilian unemployment rate was unchanged at 4.5 percent. Industrial production declined considerably in June and July; most of the drop over the two months reflected the GM strike. A decline in total retail sales in July was more than accounted for by a sharp contraction in spending for motor vehicles. Residential sales and construction have remained exceptionally strong in recent months. Available indicators point to continued growth in business capital spending, although apparently at a more moderate pace than earlier in the year. Business inventory accumulation slowed sharply in the spring. The nominal deficit on U.S. trade in goods and services widened substantially further in the second quarter. Trends in wages and prices have remained stable in recent months.

Most interest rates have fallen slightly on balance since the meeting on June 30–July 1. Share prices in U.S. equity markets have remained volatile and major indexes have declined appreciably on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar rose somewhat further over the intermeeting period in relation to other major currencies; in addition, it was up slightly in terms of an index of the currencies of the developing countries of Latin America and Asia that are important trading partners of the United States.

After robust growth in the second quarter, M2 decelerated somewhat and M3 was about unchanged in July. For the year through July, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appears to have moderated somewhat in recent months after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting on June 30–July 1 the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Vote against this action: Mr. Jordan.

Mr. Jordan dissented because he believed that the underlying strength of aggregate demand in the U.S. economy would remain fundamentally intact, despite economic problems abroad. The problems in Asia provide a channel for economic imbalances to develop. Exports from some U.S. manufacturing industries will decline due to softer foreign markets and import competition. At the same time, domestic demand for imports, housing, and consumer durables will increase due to favorable interest rate trends. Though U.S. production of goods and services might slow during the period ahead, it is not yet clear that total demand will diminish at a comparable pace. At the same time, ample credit provision encourages speculative lending and excessive consumption. Consequently, continued rapid growth in the money supply creates the risk that inflation will accelerate and economic imbalances will become protracted.

Telephone Conference

On September 21 the Committee held a telephone conference to discuss recent developments in domestic and international financial markets and their implications for the U.S. economy. The consultation was held as background for Chairman Greenspan's testimony on September 23 before the Senate Budget Committee.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 29, 1998.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Meeting Held on September 29, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 29, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Truman, Economist

Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors[5]

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Struckmeyer, Assistant Director, Division of Research and Statistics, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Spillenkothen and Parkinson,[6] Director, Division of Supervision and Regulation, and Associate Director, Division of Research and Statistics respectively, Board of Governors

5. Attended portion of the meeting relating to the Committee's disclosure policies.

6. Attended portion of meeting relating to developments stemming from the financial difficulties of a large hedge fund.

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Messrs. Eisenbeis, Goodfriend, Hunter, Kos, Lang, and Rolnick, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Chicago, New York, Philadelphia, and Minneapolis respectively

Messrs. Judd and Rosengren, Vice Presidents, Federal Reserve Banks of San Francisco and Boston respectively

Ms. Yucel, Research Officer, Federal Reserve Bank of Dallas

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 18, 1998, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period August 18, 1998, through September 28, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that economic activity was expanding at a moderate rate. Growth of private domestic final demand had slowed from its pace in the first half of the year, though it was still relatively robust, and reduced spending on U.S. exports and rising import competition were exerting appreciable restraint on overall activity, as was a slowing in inventory investment. Reflecting the moderation in growth from the first half of the year, total payroll employment was trending up at a somewhat slower pace. Despite the pressures on labor resources associated with still-tight labor markets, trends in wages and prices remained stable.

Growth in nonfarm payroll employment slowed somewhat over the July–August period. The deceleration reflected further job losses in the manufacturing sector, notably in the apparel and electronic components industries on which the crisis in Asia was having a sizable adverse effect. Outside of manufacturing, employment increases remained strong in the service-producing industries, and even though anecdotal reports continued to indicate shortages of skilled workers, further sizable job gains were recorded in construction. The civilian unemployment rate stayed at 4.5 percent in August.

Industrial output rebounded in August as production at General Motors resumed following the settlement of the labor strike. Outside the motor vehicle sector, however, output had changed little on balance over recent months in association with the erosion in net exports stemming from the turmoil in Asia and its repercussions on a number of other U.S. trading partners; production of consumer goods edged down on balance in July and August, and the growth of output of business equipment slowed. The rise in industrial production in August boosted the rate of utilization of manufacturing capacity, but the factory operating rate remained somewhat below the level of late last year.

Total retail sales were held down in July and August by a sharp contraction in spending for motor vehicles, but nonauto sales continued to rise at a brisk pace. The gains were widespread, with increases in spending on furniture and appliances, apparel, and miscellaneous nondurables especially strong. Purchases of services also were up appreciably further in July and August after a rapid second-quarter rise. Sales and construction of residential buildings remained quite strong on balance, reflecting very favorable homebuying conditions. Housing starts slipped in August but were still above the high level of the first half of the year. Sales of existing homes dropped back in August from the record high registered in July, while sales of new homes were slightly higher in July (latest data) than in the first half of the year.

Available indicators pointed to more moderate growth in business fixed investment after the surge in capital spending during the first half of the year. Shipments of nondefense capital goods declined in July and August, retracing much of June's large increase, while sales of medium and heavy trucks continued to increase at a rapid pace. Nonresidential construction weakened in July, extending a pattern of sluggish building activity; construction of industrial structures remained in a downtrend, and office building activity changed little on balance over June and July.

Business inventory accumulation eased further in July after having slowed sharply in the second quarter, and inventory–sales ratios remained moderate. Stockbuilding in manufacturing was at a somewhat lower rate in July than in the second quarter, and the stock–shipments ratio for the sector stayed a little above the low level that had prevailed over the past year. At the wholesale level, a further decline in inventories reflected additional reductions in motor vehicles; the inventory–shipments ratio remained in the upper part of its narrow range for the past year. In the retail sector, a sharp drop in stocks at automotive dealerships more than offset a rise in stocks of other goods. The aggregate inventory–sales ratio for the retail sector was at a relatively low level.

The nominal deficit on U.S. trade in goods and services narrowed slightly in July from its second-quarter average, with the value of imports falling more than the value of exports. Much of the decline in imports and exports involved trade in automotive products with Canada and Mexico. Economic activity in the major foreign industrial countries other than Japan decelerated on average in the second quarter, with a deterioration in net exports partially offsetting continued strength in domestic final demand. In Japan, activity contracted for a third consecutive quarter; net exports made a large positive contribution as imports dropped sharply, but domestic demand, most notably business fixed investment, fell steeply.

Both the overall and the core CPI again rose moderately in August; a further increase in food prices was offset by a sizable decrease in energy prices. For the twelve months ended in August, core consumer prices rose slightly more than they had in the year-earlier period. At the producer level, prices of finished goods dropped appreciably in August, largely reflecting declines in the prices of finished foods and, notably, energy goods. Producer prices of finished goods other than food and energy moved slightly higher in the twelve months ended in August after having edged down in the year-earlier period. Producer prices at earlier stages of production were under strong downward pressure; prices of intermediate materials fell during the year ended in August by slightly more than they had risen in the year-earlier period, and prices of crude materials plunged further in the twelve months ended in August. Average hourly earnings of production or nonsupervisory workers continued to increase at a relatively moderate pace in the July–August period, and for the twelve months ended in August they rose slightly more than in the year-earlier period.

At its meeting on August 18, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that would be consistent with the federal funds rate continuing to average around 5½ percent. However, in light of mounting financial strains abroad, their potential implications for the U.S. economy, and less accommodative conditions in domestic financial markets, the Committee concluded that the risks to the outlook were no longer tilted toward rising inflation but had become more balanced. Accordingly, the Committee adopted a directive that did not include a presumption about the likely direction of any adjustment to policy during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with moderate growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate remained close to its intended level of 5½ percent. In an atmosphere of greatly increased volatility in financial asset values worldwide and a reduced appetite for risk among many investors, interest rates on U.S. Treasury securities, and to a much smaller extent on investment-grade corporate debt, fell appreciably during the intermeeting period; in contrast, yields on the bonds of lower-rated firms increased sharply, and a number of large banks tightened terms and standards for making business loans to sizable firms. Credit conditions also tightened in Europe, Asia, and Latin America. Share prices in U.S. and foreign equity markets remained volatile during the intermeeting period, and major U.S. equity price indexes declined considerably further on balance.

In foreign exchange markets, the trade-weighted value of the dollar depreciated substantially over the intermeeting period in relation to other major currencies. A spreading perception that the United States was more vulnerable than either Europe or Japan to an economic downturn in Latin America, increasing expectations of monetary easing in the United States, and shifts into yen associated with the end of the fiscal half-year in Japan and the unwinding of some investment positions financed in yen were factors that weighed on the dollar. By contrast, the dollar appreciated slightly in terms of an index of currencies that includes the developing countries of Latin America and Asia that are important trading partners of the United States.

Growth of M2 and M3 picked up considerably in August and apparently strengthened further in September. The acceleration was the result of unusually large inflows to money market funds that in part reflected households' preference for relatively safe, liquid placements for funds shifted out of equities and lower-rated corporate debt. For the year through September, both aggregates recorded growth rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt had moderated somewhat in recent months after having picked up earlier in the year.

The staff forecast prepared for this meeting incorporated a considerably weaker assessment of underlying aggregate demand, owing to downward revisions to growth abroad and to the less accommodative conditions that were evolving in U.S. financial markets. The staff projected that the expansion of economic activity would slow for a time to a pace appreciably below the estimated growth of the economy's potential and then would pick up to a rate more in line with that potential. Damped expansion of foreign economic activity and the lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place considerable restraint on the demand for U.S. exports for a period ahead and to lead to further substitution of imports for domestic products. Domestic production also would be held back for a while by the efforts of firms to bring inventories into better balance with the anticipated moderation in the trajectory of final sales. In addition, private final demand would be restrained by tighter lending terms and conditions as well as the drop that had occurred in equity prices. Pressures on labor resources were likely to ease somewhat as the expansion of economic activity slowed, but inflation was projected to pick up gradually in association with a partial reversal of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic conditions, members focused on developments that pointed to the potential for a significant weakening in the growth of spending. They recognized that there were at present few statistical indications that the economy was on a significantly slower growth track. Indeed, the available data suggested that consumer expenditures and business investment retained considerable strength. At the same time, however, investors' perceptions of risks and their aversion to taking on more risk had increased markedly in financial markets around the world. That change in sentiment was exacerbating financial and economic problems in a number of important trading partners of the United States. In addition, it was generating lower equity prices and tightening credit availability in U.S. financial markets. As a consequence, the downside risks to the domestic expansion appeared to have risen substantially in recent weeks. Though labor markets were expected to remain relatively tight for some time, the members saw little prospect that inflation would gather significant momentum in coming quarters. Declining commodity and other import prices would be restraining prices and inflation expectations for a while. Overall consumer prices might rise a little more rapidly next year as the effects of a number of favorable factors, such as falling energy prices, diminished or reversed, but underlying inflation was expected to stay quite subdued as inflation expectations remained damped and pressures in labor markets became less pronounced.

The intensification and further spread of turmoil in international financial markets, notably since the outbreak of a financial crisis in Russia in mid-August, had spilled over into U.S. financial markets. Strong demands for safety and liquidity had driven down yields on U.S. Treasury securities, but spreads of private rates over Treasury rates had gapped higher. Increases in risk spreads were especially large for lower-grade borrowers and on bonds below investment grade, whose rates had increased considerably since mid-August. In addition, many banks had tightened their credit standards and terms. Prices in U.S.

equity markets, which had weakened appreciably before the crisis in Russia, had declined substantially further. These market developments strongly suggested, and anecdotal reports tended to confirm, the emergence of widespread perceptions of greater risks in a broad range of financial investment activities and of considerably greater reluctance to put capital at risk. The members did not believe that the tightness in credit markets and strong demand for safety and liquidity were likely to lead to a "credit crunch," though some members expressed the view that such an outcome could not be ruled out. At a time when business balance sheets already indicated a significant softening of cash flows owing to weaker profits, many business firms were experiencing increased difficulty and costs in their efforts to raise funds in debt or equity markets or to borrow from lending institutions; if these conditions were to persist, the sustainability of the current strength in business capital expenditures would come into question. The decline in stock market prices also appeared likely to damp the growth of consumer spending over time, with added implications for business capital expenditures.

Despite the emergence of decidedly less hospitable financial conditions, there were few indications in the data available to the Committee of any weakening as yet in consumer and business spending. Consumer expenditures, though temporarily held back by shortages of new motor vehicles stemming from the work stoppage at General Motors, had remained on a solid uptrend, with overall growth in recent months apparently slipping only a little from a remarkably rapid pace in the first half of the year. Strong growth in jobs and incomes along with substantial further increases in stock market prices through mid-July had fostered a high level of consumer confidence and spending. Members commented that the more recent weakness in the stock market and the related decline in household net worth had removed an important support for the growth of consumer spending, but they noted that recent surveys indicated only a slight deterioration in consumer sentiment and that the stimulus from earlier stock market gains probably would dissipate only gradually. Looking further ahead, consumer spending could be expected to expand at a pace that was more in line with the growth of household incomes than it had been in recent years.

Growth in business investment spending, while apparently moderating from an extraordinary pace during the first half of the year, likewise seemed to have been little affected to date by the tightening in credit conditions and the increased aversion to risktaking. Data on shipments of capital equipment continued to display a clear uptrend, and members reported very strong construction activity in many parts of the country. Declining relative prices and rapid technological advances were likely to generate appreciable further growth in spending for computer and office equipment over the projection horizon. Moreover, new orders for capital equipment did not suggest any general weakening, though such orders had declined dramatically in the steel industry under the weight of intense foreign competition. Even so, the members anticipated that the pronounced increase in investor and lender perceptions of risk would result in considerable moderation in the growth of overall business investment, especially in light of concurrent expectations of reduced gains in sales and profits and evidence of some diminution in both internal and external sources of financing. Reports from nearly every Federal Reserve District suggested that executives had become considerably more concerned about business prospects. In a number of cases they already had seen a substantial downturn in their exports or a surge in competing imports at prices they found difficult to match. In other cases they were anticipating such developments or were reacting to the general sense of unease and uncertainty evident in financial markets. Forthcoming data on capital spending, including new orders and contracts, were likely to point to a weaker uptrend in business fixed investment. How much weaker was a major uncertainty in the economic outlook and a key to determining the extent to which financial market turmoil was likely to affect the real economy.

Very favorable underlying factors, including a strong job market and declining mortgage rates, had helped to sustain homebuilding activity at an elevated level. The large further advance in stock market prices earlier in the year also appeared to have been a positive factor in the strong performance of the housing market. While anecdotal reports suggested that softening was confined to only a few areas, the delayed effects of the drop in stock market prices and forecasts of slower employment and income growth suggested some moderation in housing activity at some point. Even so, the continued affordability of new homes for many households was likely to sustain housing demand at a relatively high albeit diminished level, and homebuilding activity would be bolstered for a time as backlogs created by shortages of skilled construction workers in many areas were worked off.

Net exports, while subject to a great deal of uncertainty, were seen as likely to continue to restrain demand and production to a substantial extent over coming quarters. Members cited examples from across the country of business firms, notably in the manufacturing sector but also in energy, agriculture, forest products, and some other industries, that already were being adversely affected by weaker export markets and increased competition from lower-priced imports. Moreover, the intensification of turmoil in international financial markets since the Russian devaluation and debt moratorium had led to tighter financial conditions in key U.S. trading partners—especially in the Americas—a development that was likely to weaken growth in those markets and demand for U.S. products. Of potentially greater importance for the domestic economic outlook, however, was the spread of international financial unsettlement to U.S. financial markets and the attendant deterioration in business and investor confidence. It was clear that the contagious effects of international economic and financial turmoil had markedly increased the downside threat to the domestic expansion.

In their comments about the outlook for inflation, members referred to the persistence of very tight labor markets across the nation and to indications of escalating increases in labor compensation in a number of areas. At the same time, price inflation generally had remained subdued, with little evidence of acceleration. As had been true for an extended period, competitive pressures were widely reported to be preventing employers from passing through rising labor costs to consumer prices. Looking ahead, members cited a variety of factors bearing on the prospects for inflation that on the whole suggested that the risks of an inflationary uptrend had receded. Favorable factors in the outlook for prices included the lingering effects of the dollar's earlier appreciation, ample industrial capacity, generally declining commodity and other import prices, and an apparently more rapid trend of productivity gains. Over time, some slowing in economic growth and less intense pressures on labor resources would hold down increases in labor costs. Developments that might tend to offset these positive factors, at least in part, included a possible turnaround in energy prices after sizable declines over the past year and an upturn in the costs of worker benefits, notably for medical expenses. A few members also observed that the rapid growth of key monetary aggregates, including M2, over a period of several quarters was a worrisome element in the outlook for inflation, though the most recent surge in M2 probably was induced in large measure by a flight to quality and liquidity.

In their discussion of policy for the intermeeting period ahead, all the members endorsed a proposal calling for a slight easing in reserve markets to produce a decline of ¼ percentage point in the federal funds rate to an average of about 5¼ percent. In their view, such an action was desirable to cushion the likely adverse consequences on future domestic economic activity of the global financial turmoil that had weakened foreign economies and of the tighter conditions in financial markets in the United States that had resulted in part from that turmoil. At a time of abnormally high volatility and very substantial uncertainty, it was impossible to predict how financial conditions in the United States would evolve. In the view of many members, equity prices and risk spreads in U.S. financial markets previously had embodied an overly optimistic assessment of business prospects, and they saw some correction in these markets as a positive development. Moreover, they expected markets to become much more settled once the initial adjustments to new risk assessments had been made. On balance, however, credit conditions were likely to remain tighter and equity prices lower than earlier, and in the context of continued damped inflation, monetary policy had the room to adjust to these new circumstances. In any event, an easing policy action at this point could provide added insurance against the risk of a further worsening in financial conditions and a related curtailment in the availability of credit to many borrowers.

The members agreed that the decrease in the federal funds rate should be limited to 25 basis points. Several emphasized in this regard that although the risk of rising inflation might have receded, it was still present, especially in light of the persistence to date of very tight labor markets and relatively robust economic growth. In these circumstances, while an easing move was warranted to provide some insurance against undesirably tight domestic financial conditions, many members saw the need for a cautious policy action. A more sizable policy move at this point might convey an exaggerated impression of the Committee’s current thinking regarding the extent of downside risks in the economy.

The members were divided over whether to retain the current symmetrical directive or to adopt an asymmetrical directive that would be tilted toward ease. A small majority favored moving to asymmetry on the grounds that it seemed more consistent with the increased downside risks to the economy that they believed would exist even after the contemplated policy action and that it would underscore the Committee’s readiness to respond promptly to conditions that might threaten the sustainability of the expansion. Other members expressed a preference for a symmetric directive but indicated that they could accept a directive that was tilted toward ease. In their opinion, the uncertainties relating to the direction of the next policy move were sufficiently great on both sides to justify a neutral directive. Some commented that unanticipated developments were likely in any event to provide the principal basis for future policy actions. They suggested that the Committee would undoubtedly confer by telephone should such developments materialize during the intermeeting period, and the symmetry or asymmetry of the directive would have little bearing on whatever policy decision might be reached.

At the conclusion of the Committee's discussion, all the members supported a directive that called for conditions in reserve markets that would be consistent with a slight decrease in the federal funds rate to an average of about 5¼ percent. All the members also indicated that they could accept a change in the directive to include a bias toward easing. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a slightly higher federal funds rate might be acceptable or a somewhat lower federal funds rate would be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the growth of M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that the economy has been growing at a moderate rate, paced by brisk, albeit slowing, increases in spending by businesses and households, while expansion in overall economic activity has continued to be restrained by developments abroad. Nonfarm payroll employment grew somewhat more slowly over July and August, mostly reflecting job losses in the manufacturing sector; the civilian unemployment rate was unchanged at 4.5 percent in August. Industrial production has changed little on balance over recent months. Total retail sales over July and August were held down by a sharp contraction in spending for motor vehicles. Residential sales and construction have remained quite strong in recent months. Available indicators point to continued growth in business capital spending, but at a more moderate pace than in the first half of the year. Business inventory accumulation slowed further in July. The nominal deficit on U.S. trade in goods and services narrowed slightly in July from its second-quarter average. Trends in wages and prices have remained stable in recent months.

Most interest rates have fallen appreciably since the meeting on August 18, though yields on the bonds of lower-rated firms have increased and a number of large banks have tightened terms and standards for making business loans. Broadly similar developments have occurred in major foreign markets. Share prices in U.S. and global equity markets have remained volatile and major indexes have declined considerably further on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar declined substantially over the intermeeting period in relation to other major currencies; it was up slightly in terms of an index of the currencies of the developing countries of Latin America and Asia that are important trading partners of the United States.

Growth of M2 and M3 strengthened considerably in August and appeared to have picked up further in September, partly reflecting shifts of funds by households out of investments in equities and lower-rated corporate debt. For the year through September, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt has moderated somewhat in recent months after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting on June 30–July 1 the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with decreasing the federal funds rate to an average of around 5¼ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate might or a somewhat lower federal funds rate would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Votes against this action: None.

Release of Information about FOMC Meetings

At this meeting, the Committee reviewed its current practices relating to its policy announcements, meeting minutes, and directive wording. This discussion was part of an ongoing appraisal of the Committee's disclosure policies. The Committee took no action at this meeting but agreed that further review of some of these issues would be appropriate.

Financial Problems of a Large Hedge Fund

The Committee discussed the limited role of the Federal Reserve Bank of New York in facilitating a private-sector resolution of the severe financial problems encountered in the portfolio managed by Long-Term Capital Management L.P. The size and nature of the positions of this fund were such that their sudden liquidation in already unsettled financial markets could well have induced further financial dislocations around the world that could have impaired the economies of many nations, including that of the United States. Against this background, the Federal Reserve Bank of New York had brought together key interested parties with the aim of increasing the probability of an orderly private-sector solution to the hedge fund's difficulties.

It was agreed that the next meeting of the Committee would be held on Tuesday, November 17, 1998.

The meeting on September 29 adjourned at 2:40 p.m.

After the meeting, the following press release was issued:

The Federal Open Market Committee decided today to ease the stance of monetary policy slightly, expecting the federal funds rate to decline ¼ percentage point to around 5¼ percent.

The action was taken to cushion the effects on prospective economic growth in the United States of increasing weakness in foreign economies and of less accommodative financial conditions domestically. The recent changes in the global economy and adjustments in U.S. financial markets mean that a slightly lower federal funds rate should now be consistent with keeping inflation low and sustaining economic growth going forward.

The discount rate remains unchanged at 5 percent.

Conference Call

In a telephone conference held on October 15, 1998, the Committee members discussed recent economic and financial developments and their implications for monetary policy. Risk aversion in financial markets had increased further since the Committee's meeting in September, raising volatility and risk spreads even more, eroding market liquidity, and constraining borrowing and lending in a number of sectors of the financial markets. Although indications of any softening in the pace of the economic expansion across the country remained sparse, the widespread signs of deteriorating business confidence and evidence of less accommodative domestic financial conditions suggested that the downside risks to the expansion had continued to mount.

Against this background, a consensus emerged in favor of a ¼ percentage point reduction in the federal funds rate that would accompany a reduction in the discount rate that the Board of Governors was expected to approve at a meeting following this telephone conference. Some members were concerned that a policy move so soon after the late September action might be misread as indicative of a degree of concern about prospective developments in financial markets or the economic outlook that did not represent the Committee's thinking. However, the members generally concluded that the risk of adverse market reactions was worth taking and that the easing actions under consideration were more likely to help settle volatile financial markets and cushion the effects of more restrictive financial conditions on the ongoing expansion. At the conclusion of this discussion, the Chairman indicated that he would instruct the Federal Reserve Bank of New York to lower the intended federal funds rate by 25 basis points, consistent with the Committee's directive issued at the meeting on September 29, 1998.

Donald L. Kohn
Secretary

On October 15, 1998, the following press release was issued:

The Federal Reserve today announced the following set of policy actions:

- The Board of Governors approved a reduction in the discount rate by 25 basis points from 5 percent to 4¾ percent.
- The federal funds rate is expected to fall 25 basis points from around 5¼ percent to around 5 percent.

Growing caution by lenders and unsettled conditions in financial markets more generally are likely to be restraining aggregate demand in the future. Against this backdrop, further easing of the stance of monetary policy was judged to be warranted to sustain economic growth in the context of contained inflation.

In taking the discount rate action, the Board approved requests submitted by the Boards of Directors of the Federal Reserve Banks of New York, Philadelphia, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, and San Francisco. The discount rate is the interest rate that is charged depository institutions when they borrow from their district Federal Reserve Banks.

Meeting Held on November 17, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, November 17, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist

Messrs. Cecchetti, Dewald, Lindsey, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Johnson, Director, Division of International Finance, Board of Governors

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Alexander and Hooper, Deputy Directors, Division of International Finance, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Whitesell, Assistant Director, Division of Monetary Affairs, Board of Governors

Ms. Garrett, Economist, Division of Monetary Affairs, Board of Governors

Mr. Kumasaka, Assistant Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Moore, First Vice President, Federal Reserve Bank of San Francisco

Messrs. Beebe, Eisenbeis, Ms. Krieger, Messrs. Lang, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, New York, Philadelphia, and Dallas respectively

Messrs. Evans, Fuhrer, Hetzel, Miller, and Sellon, Vice Presidents, Federal Reserve Banks of Chicago, Boston, Richmond, Minneapolis, and Kansas City respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on September 29, 1998, were approved. The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period September 29, 1998, through November 16, 1998. By unanimous vote, the Committee ratified these transactions.

The Manager informed the Committee that he planned to initiate outright purchases in the secondary market of inflation-indexed Treasury securities. In the past, the System had been acquiring holdings of such securities in Treasury auctions in exchange for maturing nominal obligations. In the Manager's opinion, secondary market transactions would provide a helpful addition to the current range of assets that the System normally purchased, especially in a period of little or no increase in Treasury debt. Some members expressed concern that sizable purchases of indexed securities by the central bank might impair the liquidity of the market and limit the usefulness of these obligations as indicators of inflationary expectations. It was noted, however, that relatively limited System purchases of such securities were contemplated so that the market was not likely to be significantly affected. Moreover, the System's participation could contribute to a more active and liquid secondary market.

In further discussion of the wording of the operating paragraph of its directive, the Committee at this meeting focused on proposals by members to simplify and clarify the sentence relating to the symmetry or asymmetry of the directive as it applied to possible future policy changes. Time constraints did not permit the Committee to complete its deliberations, and it agreed to continue its discussion at a later meeting.

The Committee then turned to the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York. Committee decisions to amend the Authorization for Domestic Open Market Operations and to renew certain swap line agreements also are summarized below.

The information reviewed at this meeting suggested some moderation in the expansion of economic activity from a brisk pace during the summer months. Although growth of economic activity in the third quarter apparently about matched the pace in the first half of the year, a large buildup of nonfarm inventories had accounted for a significant portion of the persisting strength of the expansion during the quarter. Growth in consumer spending had been well maintained during the summer months, and housing activity had remained at a high level. In other major sectors of the economy, business fixed investment had softened after having surged in the first half, and net exports had declined further, although at a reduced pace. Growth in employment had slowed appreciably on balance during the summer and early fall months, but tight conditions had persisted in most labor markets. Recent wage and price developments had been mixed.

Growth in nonfarm payroll employment slowed appreciably in September and October. The slowing partly reflected sizable job losses in manufacturing, which has been substantially affected since earlier in the year by rising foreign competition stemming from the crisis in Asia. Outside of manufacturing, increases in employment in the service-producing industries moderated somewhat over the two months, although gains in finance, insurance, and real estate were relatively robust. The civilian unemployment rate remained near 4½ percent during the two months.

Industrial output had declined slightly in recent months after having rebounded in August when production resumed at General Motors following settlement of the labor strike. Outside the motor vehicle sector, manufacturing output edged lower in recent months after having decelerated markedly earlier in the year. Weakness in the manufacturing and mining sectors was associated in large measure with the fallout from the turmoil in Asia, its repercussions on a number of U.S. trading partners, and the related softness in world oil markets. The downward trend in the utilization of capacity in manufacturing left the factory operating rate appreciably below its level of late last year.

Personal consumption expenditures rose considerably further during the third quarter, though at a much slower pace than that recorded earlier in the year. Retail sales were down slightly on balance during the quarter, reflecting a sharp drop in sales of motor vehicles associated with the work stoppage at General Motors. However, the settlement of that strike and the resumption of production led to an upturn in motor vehicle sales in August and a sizable advance in September. A large further gain in such sales contributed to a sharp rise in overall retail sales in October. Consumer confidence retreated further in October, but according to a major survey it turned up in early November, albeit to a level still somewhat below its peak earlier in the year.

Available indicators pointed to a pickup in business capital spending after a third-quarter lull, owing to some extent to a recovery from the General Motors strike. Business investment expenditures during the summer were held down in part by the strike-related decline in fleet sales of new motor vehicles. In addition, spending for other types of business equipment grew somewhat more slowly in the third quarter after having expanded at an extraordinary pace earlier in the year. Orders received by U.S. equipment makers continued to trend up through September. In contrast, nonresidential building activity apparently fell somewhat further in the third quarter. While the construction of lodging facilities surged and the construction of office space persisted at a high level, there was a decline in other commercial building, which includes retail stores and warehouses, industrial structures, and institutional buildings. The availability of financing for various types of construction appeared to lessen substantially in late summer, and financing costs rose for many borrowers.

In the residential sector, housing sales and starts remained quite strong, though below early summer highs. Housing activity showed signs of dropping off from peak levels during the latter part of the summer, but the decline in mortgage rates this fall produced an upturn in several indicators of demand for single-family housing, including a rebound in a survey index of homebuying conditions. Multifamily housing starts increased considerably in the third quarter, but since late summer the availability of financing for multifamily building projects has tended to diminish and interest costs to rise.

Business inventory accumulation was sizable in the third quarter, and stocks–sales ratios rose to uncomfortable levels in some industries that were being adversely affected by the nation's growing trade deficit. In manufacturing, however, stockbuilding slowed during the summer months and the stock–shipment ratio was unchanged at a level just above its average for the past year. At the wholesale level, a rapid increase during the third quarter lifted the inventory–sales ratio for this sector to its highest level since 1986; nearly half the rise was the result of a buildup of farm products that was related in part to an early harvest, but wholesalers of machinery, chemicals, and metals and minerals also apparently experienced undesired buildups of stocks. Retail inventories excluding motor vehicles accumulated at a slow pace during the summer, and the inventory–sales ratio for this category remained well within the narrow range of the past year.

The nominal deficit on U.S. trade in goods and services widened to some extent in July–August from its second-quarter average. The value of imports in the July–August period, though rising appreciably in August, was somewhat below the second-quarter average, with most of the decline involving automotive products and oil. The value of exports fell somewhat over the two months, largely reflecting declines in exports of automotive products and industrial supplies and reduced service transactions. Decreases in exports partly reflected weakness in foreign economies. In the third quarter, growth in economic activity slowed on average in the major industrial countries, other than Japan, from the average pace in the first half of the year and contracted for a fourth consecutive quarter in Japan. There were widespread indications in the industrial nations, particularly from surveys of business and consumer confidence, that some slowing was persisting into the fourth quarter. Elsewhere, the available evidence pointed to some improvement in economic trends in a number of Asian nations, but the economies of several sizable South American countries appeared to have weakened. Recent economic indicators for Mexico were mixed.

The performance of various measures of wages and prices was uneven in recent months. The most recently available employment cost index indicated that hourly compensation of private industry workers posted a sizable increase in the third quarter. However, gains in average hourly earnings moderated considerably in September and October. The increase in the employment cost index over the past year was appreciably larger than in the previous year, while the advance in average hourly earnings moderated somewhat.

Consumer energy prices rose appreciably in October, but they were still down sharply from a year earlier and on balance limited the increase of overall consumer prices over the past year. Core consumer prices moved up at a faster pace than overall consumer prices in recent months and over the past year, reflecting sizable increases in the prices of tobacco, used cars and trucks, and services. At the producer level, prices of finished goods edged up in recent months but were down on balance over the past year; excluding food and energy items, producer prices rose somewhat over the past year.

At its meeting on September 29, 1998, the Committee adopted a directive that called for implementing conditions in reserve markets that were consistent with a one-quarter percentage point decrease in the federal funds rate to an average of around 5¼ percent. The Committee also decided to adopt an asymmetric directive that was tilted toward ease to highlight its view that the risks to the economic expansion were mainly on the downside and to underscore its readiness to respond promptly to developments that threatened the sustainability of the expansion. The reserve conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over subsequent months.

Following the meeting, open market operations were directed initially toward implementing a slight easing in the degree of pressure on reserve positions. The federal funds rate, responding to quarter-end pressures and uncertainties created by shifting funding patterns in volatile financial markets, tended at first to average somewhat above the intended rate of 5¼ percent despite a relatively liberal provision of reserves by the System. Strains in financial markets continued to mount, with intermediaries and final investors much more cautious about risks and leverage and much more eager to hold very liquid assets. These developments in turn disrupted flows of funds in a number of financial markets. On October 15, the Committee discussed these developments and their implications for the domestic economy, and the members supported the Chairman's suggestion that, in keeping with the directive issued at the September 29 meeting, he instruct the Federal Reserve Bank of New York to reduce the intended federal funds rate by a further 25 basis points to around 5 percent. On the same day, the Board of Governors approved a reduction in the discount rate from 5 percent to 4¾ percent. These actions were taken in the light of growing indications of caution by lenders and unsettled conditions in financial markets more generally that were deemed likely to restrain aggregate demand in the future. Subsequently, trading in the federal funds market remained relatively volatile but the federal funds rate averaged close to its lower intended level. In financial markets more generally, strains gradually moderated after mid-October and sizable issuance of securities resumed in a number of key markets, but uncertainty remained high and relatively illiquid conditions persisted. In the stock market, share prices dropped in the weeks following the September meeting, but the market rallied strongly after mid-October and key market indexes posted sizable gains on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar fell moderately over the period in relation to other major currencies. The largest decline occurred in relation to the Japanese yen and appeared to reflect efforts to reduce speculative exposure to that currency; changes in the value of the dollar against other major currencies were mixed, likely fostered by disparate interest rate and economic developments. The dollar also fell somewhat in terms of a broad index of currencies of other countries that are important trading partners of the United States, including the developing nations of Latin America and Asia.

M2 and M3 posted very large increases in September and October. The gains appeared to be induced to an important extent by increased demand for safe and liquid assets in a period of substantial turmoil in financial markets that led to shifts of funds by households out of investments in equities and lower-rated corporate debt. The advance in M2 during October probably also was boosted by the decline in its opportunity cost resulting from the effects of the System's easing actions on market interest rates and the unusual softness in Treasury bill rates during much of the month. The even faster increase in M3 in October also reflected both inflows to institution-only money market mutual funds that were stimulated by declines in short-term market rates and bank efforts to fund heavy demand for loans arising in part from the deflection of demand for funding from securities markets. For the year through October, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt moderated slightly in recent months after having picked up earlier in the year.

The staff forecast prepared for this meeting continued to point to considerable slowing in the expansion of economic activity to a pace appreciably below the estimated growth of the economy's potential, but the expansion was expected to pick up later to a rate more in line with that potential. Subdued expansion of foreign economic activity and the lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place considerable, albeit diminishing, restraint on the demand for U.S. exports for some period ahead and to lead to further substitution of imports for domestic products. Domestic production would also be held back for a time by the efforts of firms to bring inventories into better balance with the anticipated moderation in the trajectory of final sales. In addition, private final demand would be restrained a bit by the tighter terms and conditions that were now imposed by many types of lenders and by the anticipated waning of positive wealth effects stemming from earlier increases in equity prices. Pressures on labor resources were likely to ease somewhat as the expansion of economic activity moderated, but inflation was projected to rise considerably over the year ahead in association with a partial reversal of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic developments, members observed that indications of some moderation in the pace of the economic expansion were still quite limited, but they generally agreed that the economy appeared to be headed toward slower growth. Relatively tight profit margins and less ebullient growth in wealth were among the factors expected to be damping investment and consumption. In addition, even apart from the possibility of further financial contagion in Latin America, the weakness in foreign economies continued to be seen as a persistent source of restraint on demand in a number of domestic sectors, notably manufacturing, agriculture, and some extractive businesses. Although the financial markets had improved substantially in recent weeks, overall credit conditions were still relatively unsettled and a possible reintensification of difficulties in credit markets constituted an important downside risk to the expansion. The members recognized that not all the risks were in one direction, however. The economy had demonstrated remarkable resilience and strength over recent years, and in the view of some members the rapid growth of liquidity and bank credit suggested that financial conditions were not excessively tight. With regard to the outlook for inflation, members noted that while statistical and anecdotal information pointed to persistently tight labor markets in much of the nation, price inflation remained subdued. Indeed, even though the recent evidence relating to prices was somewhat mixed, several broad measures of prices suggested that inflation might be on a declining trend.

In the course of the Committee's discussion, the members gave considerable attention to recent financial developments and their implications for the economic outlook. Financial markets clearly had calmed markedly since the System's easing actions in mid-October, though they were still atypically volatile. Risk spreads had narrowed substantially and other measures of financial market performance also suggested that risk aversion and the related desire for liquidity had diminished appreciably. Markets for new issues had reopened for many borrowers, and stock market prices had posted large gains. Nonetheless, strains and weaknesses in financial markets had not disappeared—many risk spreads were still at unusually high levels—and the markets remained quite sensitive to unanticipated developments. Members also noted that the improvement in debt markets appeared to have come to a halt most recently and that renewed strains had emerged in some short-term debt markets, though the latter probably were related in large measure to concerns about year-end pressures in the money markets. Indeed, efforts by lenders and borrowers to position for year-end financial statements were likely to contribute considerably to keeping market conditions unsettled over coming weeks. Lending activity at banks had increased sharply in recent months as many borrowers found other sources of funds less receptive or unavailable and turned to backup lines for credit, but banks also had tightened their credit terms and standards for most new loans and lines of credit. As a result, financing generally had become less available and more expensive for higher-risk business borrowers. In light of these developments, members believed that the continuing fragility of financial markets and the increased scrutiny of the credit quality of borrowers, though the latter was in some respects a welcome development, posed a considerable downside risk to the expansion. The very recent behavior of equity prices was difficult to explain satisfactorily, and potential movements in those prices posed risks on both sides of the most likely forecast: A future substantial increase would bolster wealth and spending, but a sharp decline also could not be ruled out—especially if, as seemed quite possible, added increases in prices were not supported by robust increases in profits.

Foreign economic and financial developments were another important source of downside risk and uncertainty. The economic and financial turmoil in Asia had spread to numerous other nations around the world and to an extent to the United States. While economic weakness in many U.S. trading partners likely would continue to have adverse effects on net U.S. exports, the potential extent of such weakness was subject to considerable uncertainty as were the associated repercussions on financial markets. As they had at previous meetings, members referred to numerous anecdotal reports of heightened competition from foreign producers that was curbing the sales of many domestic manufacturers, notably in the steel industry, and in some other industries and agriculture. Moreover, the low level of world oil prices, which appeared to be importantly associated with diminished demand from Asian countries, was retarding production and reducing revenues in the U.S. energy and related industries. On the positive side, members commented that economic and financial conditions appeared to have stabilized or improved a bit in a number of Asian nations, though the recession in Japan showed little evidence of coming to an end, and the outlook for Brazil seemed a little more promising. However, economic and financial conditions in Brazil and a number of other countries remained very fragile. The recent depreciation of the dollar, while perhaps putting some upward pressure on prices, would damp the deterioration in net U.S. exports.

In their review of recent and prospective developments across the nation and in key sectors of the economy, members referred to scattered indications of some slowing in private domestic final demands. In the important consumer sector, however, evidence of weakening growth in expenditures was quite limited. The most recent anecdotal reports pointed to solid growth in most though not all regions of the country, and retail sales posted a strong advance in October. Moreover, consumer sentiment remained at a high level, albeit below its peak earlier in the year according to a recent survey. Members commented, however, that the more moderate growth in employment and incomes experienced recently likely would persist and should result in reduced gains in consumer expenditures next year, but they also noted that the extent of the deceleration was subject to considerable uncertainty. Some members referred to reports from contacts in the retailing industry who expressed some concern about the potential for weaker retail sales after the holiday season. A significant factor bearing on consumer spending would be the performance of the stock market. The impetus from the wealth effects of rapidly rising share prices would wane if such prices were to stabilize near current levels.

With regard to business fixed investment, anecdotal evidence was accumulating that many business firms, notably in manufacturing, were scaling back their planned capital outlays for the year ahead. Factors contributing to the prospective deceleration in business capital expenditures included a weaker trend in profits over the past several quarters, a related deterioration in business cash flows, and a large buildup in capacity over the course of recent years. Members also referred to indications of curtailed availability and more costly financing for some businesses, notably for relatively speculative construction projects. A number of members observed that the latter was a healthy development in that it would tend to hold down overbuilding in some areas. Overall, capital expenditures would undoubtedly recover from their slight decline during the summer months, but the outlook was for growth next year at a pace well below that experienced for an extended period before mid-1998. Housing construction was expected to remain at a high level, buttressed by attractive terms on new home mortgages, but housing activity appeared to have peaked or declined slightly in some regions.

The rapid buildup in inventories during the third quarter was not likely to continue, but the timing and extent of the expected moderation were largely unpredictable. It was noted in this regard that while inventories appeared to have risen to uncomfortable levels in some industries, there was no evidence of a general inventory overhang. Looking ahead, the projected slowing in the growth of final sales, including the effects of weak export markets, likely would reinforce business efforts to bring the growth of their inventories into better alignment with that of their sales, and such a development should contribute to the projected slowing in overall economic activity in coming quarters. It was unclear at this point to what extent year 2000 concerns might stimulate extra inventory investment prior to the end of 1999.

In their review of developments bearing on the outlook for inflation, members commented that labor markets remained exceptionally tight, though there was little evidence that they had tightened further in recent weeks. Employers were continuing to resist pressures to grant unusually large wage increases, and the persistence of vigorous competition, including that from Asian imports, was preventing most business firms from passing cost increases through to prices. Indeed, the declining trend in profits in recent quarters suggested that many firms were absorbing some of their rising labor costs to the extent that the latter were not offset by improvements in productivity. Looking ahead, slower growth in economic activity would tend to hold down pressures on wages and prices during 1999 and imports from Asian and other depressed economies would continue to generate intense competition in many markets; but labor markets remained tight, energy and commodity prices could well turn up after substantial declines, and the recent depreciation of the dollar would lessen pressures from foreign competition. A number of members expected that, on balance, inflation might be less favorable next year, though any deterioration in underlying trends should be relatively limited; others anticipated little change in and possibly some further ebbing of price inflation, extending the subdued behavior of a number of comprehensive measures of prices.

In the Committee's discussion of policy for the intermeeting period ahead, nearly all the members indicated that they could accept a proposal to reduce the federal funds rate by a further 25 basis points to an average of 4¾ percent. This policy decision was viewed as a close call by several members. While the growth of the economy was expected to slow appreciably over the year ahead, the expansion currently displayed only modest signs of moderating from what seemed to be an unsustainable pace. Moreover, many members saw some risk that an easing move at this point might trigger a strong further advance in stock market prices that would not be justified on the basis of likely future earnings and could therefore lead to a relatively sharp and disruptive market adjustment later. The members were more concerned, however, about the risks stemming from the still sensitive state of financial markets, and in that regard many believed that a prompt policy easing would help to ensure against a resurgence of severe financial strains. A further easing move would complete the policy adjustment to the changed economic and financial climate that had emerged since midsummer and would provide some insurance against any unexpectedly severe weakening of the expansion. Most members saw little risk that a modest easing would ignite inflationary pressures in the economy, given the subdued behavior of inflation and their outlook for economic activity. Moreover, the easing could readily be reversed if unexpected circumstances should call for such an action. In this view, the risks of inaction were greater in terms of the potential financial consequences and also could materialize much sooner than the risks of stimulating greater inflation through the slight easing that was contemplated.

Some members indicated that in light of continued robust economic growth, tight labor markets, and improving financial conditions they had a preference for awaiting further developments that might provide a stronger basis for an easing action. Some of these members expressed concern that easier reserve conditions would accommodate a step-up in monetary growth that was already quite rapid, with potentially inflationary consequences later. Nonetheless, all but one of these members could endorse the decision to ease, given the evident downside risks in the international situation, financial market uncertainty, the likelihood that inflation would still be quite low, and the possibility of reversing the action reasonably promptly should circumstances warrant.

Given its decision to ease policy, the Committee favored a change to symmetry from the asymmetry toward ease in its recent directives. A symmetrical directive was now felt to be appropriate in light of the Committee's expectation that further easing was not likely to be needed over the months ahead unless ongoing developments pointed to a more substantial decline in the growth of economic activity or further ebbing of inflation than was currently anticipated. The members recognized that the possible emergence of severe year-end pressures in the money market might require some temporary easing in reserve conditions, but such a development did not seem to have a high probability and could in any event be readily and properly accommodated regardless of the bias in the directive.

At the conclusion of the Committee's discussion, all except one member supported a directive that called for conditions in reserve markets that would be consistent with a slight decrease in the federal funds rate to an average of about 4¾ percent. These members also accepted a proposal to remove the bias toward easing that had been adopted at the previous meeting. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a slightly higher federal funds rate or a slightly lower federal funds rate would be acceptable during the the intermeeting period. A staff analysis prepared for this meeting suggested that the reserve conditions contemplated by the Committee were likely to be consistent with some moderation in the growth of M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests some moderation in the expansion of economic activity from a brisk pace during the summer months. Growth in nonfarm payroll employment slowed appreciably in September and October; the civilian unemployment rate remained near 4½ percent. Industrial production has declined slightly in recent months. Business inventory accumulation was sizable in the third quarter, and stock–sales ratios rose to uncomfortable levels in some sectors strongly affected by the nation's trade deficit. The nominal deficit on U.S. trade in goods and services widened somewhat in July–August from its second-quarter average. Total retail sales rose sharply in October after increasing only moderately in August and September. Residential sales and building starts have remained quite strong, but below recent peaks. Available indicators point to a pickup in business capital spending after a lull in the third quarter, owing in part to a recovery from the summer strike in the motor vehicle industry. Trends in various measures of wages and prices have been mixed in recent months.

Most market interest rates have risen on balance since the meeting on September 29, though yields on the bonds of lower-rated firms have declined. The Board of Governors approved a reduction in the discount rate from 5 to 4¾ percent on October 15. Share prices in U.S. and global equity markets have remained volatile but have posted sizable gains on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar declined moderately over the period in relation to other major currencies; it also fell somewhat in terms of an index of the currencies of other countries that are important trading partners of the United States.

M2 and M3 have posted very large gains in recent months, reflecting the effects of recent System easing actions on market interest rates and shifts of funds by households out of investments in equities and lower-rated corporate debt. For the year through October, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt has moderated slightly in recent months after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting on June 30–July 1 the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with decreasing the federal funds rate to an average of around 4¾ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Vote against this action: Mr. Jordan.

Mr. Jordan dissented because he believed that the two recent reductions in the federal funds rate were sufficient responses to the stresses in financial markets that had emerged suddenly in late August. An additional rate reduction risked fueling an unsustainably strong growth rate of domestic demand. He expressed concern that the excessively rapid rates of growth of the monetary and credit aggregates were inconsistent with continued low inflation. Moreover, any further monetary expansion in response to economic weakness abroad could ultimately have a disrupting influence on domestic prosperity if policy were forced to reverse course at a later date to defend the purchasing power of the dollar.

Renewal of Reciprocal Currency Arrangements with the Banks of Canada and Mexico

The Committee voted unanimously to reauthorize Federal Reserve participation in the North American Framework Agreement, established in 1994, and the associated bilateral reciprocal currency ("swap") arrangements with the Bank of Canada and the Bank of Mexico. These arrangements, which predated the North American Framework Agreement, were linked into a trilateral facility in connection with the establishment of the North American Financial Group in 1994 to facilitate consultation and cooperation among the three countries in the area of macroeconomic policy as an outgrowth of the increasing integration of those economies expected to result from the North American Free Trade Agreement.

Owing to the formation of the European Central Bank and in light of 15 years of disuse, the bilateral swap arrangements of the Federal Reserve with the Austrian National Bank, the National Bank of Belgium, the Bank of France, the German Federal Bank, the Bank of Italy, and the Netherlands Bank were jointly deemed no longer to be necessary in view of the well established present-day arrangements for international monetary cooperation. Accordingly, it was agreed by all the bilateral parties to allow them to lapse. Similarly, it was jointly agreed to allow the bilateral swap arrangements between the Federal Reserve and the National Bank of Denmark, the Bank of England, the Bank of Japan, the Bank of Norway, the Bank of Sweden, the Swiss National Bank, and the Bank for International Settlements to lapse in light of their disuse and present day arrangements for international monetary cooperation.

Authorization for Domestic Open Market Operations

On the recommendation of the Manager, the Committee voted unanimously to amend the authorization for domestic open market operations to extend the maximum maturity of System repurchase agreements from 15 calendar days to 60 calendar days. The purpose of the expanded authority was to enhance the flexibility of the Manager in meeting reserve-supplying objectives during periods of pronounced seasonal needs, notably those associated with the year-end. Subject to the Committee's approval, the Manager would initiate the System's use of extended-term repurchase agreements ahead of the coming year-end, and he anticipated that such use could prove to be especially advantageous in late 1999 to the extent that year 2000 concerns generated accentuated seasonal demand for currency. In addition, the availability of the extended funding could help to allay concerns in the federal funds market about the cost of financing during periods of peak seasonal pressures, with favorable effects on the market's functioning.

Accordingly, effective November 17, 1998, paragraphs 1(b) and 3 of the authorization for domestic open market operations were amended to read as follows:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 60 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 60 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 22, 1998.

The meeting adjourned at 1:25 p.m.

Normand Bernard
Deputy Secretary

After the meeting, the following press release was issued:

The Federal Reserve today announced the following set of policy actions:

- The Board of Governors approved a reduction in the discount rate by 25 basis points from 4¾ percent to 4½ percent.
- The federal funds rate is expected to fall 25 basis points from around 5 percent to around 4¾ percent.

Although conditions in financial markets have settled down materially since mid-October, unusual strains remain. With the 75 basis point decline in the federal funds rate since September, financial conditions can reasonably be expected to be consistent with fostering sustained economic expansion while keeping inflationary pressures subdued.

In taking the discount rate action, the Board approved requests submitted by the Boards of Directors of the Federal Reserve Banks of New York, Philadelphia, and Dallas. The discount rate is the interest rate that is charged depository institutions when they borrow from their district Federal Reserve Banks.

Meeting Held on December 22, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 22, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist

Ms. Browne, Messrs. Cecchetti, Hakkio, Lindsey, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Johnson, Director, Division of International Finance, Board of Governors

Messrs. Alexander and Hooper, Deputy Directors, Division of International Finance, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Pianalto, First Vice President, Federal Reserve Bank of Cleveland

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lang, and Rolnick, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Chicago, Philadelphia, and Minneapolis respectively

Mr. Gavin and Ms. Perelmuter, Vice Presidents, Federal Reserve Banks of St. Louis and New York respectively

Mr. Duca, Assistant Vice President, Federal Reserve Bank of Dallas

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 17, 1998, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting, and thus no vote was required of the Committee.

By unanimous vote the Committee amended the Authorization for Foreign Currency Operations to add the euro to the list of foreign currencies in which the Federal Reserve Bank of New York is authorized to conduct open market operations. The Desk's holdings of German marks will automatically be converted to euros when that currency is introduced on January 1, 1999.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period November 17, 1998, through December 21, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economy had continued to expand at a brisk pace in recent months. Domestic final demand had remained robust, and production and employment had recorded further solid gains. Trends in various measures of wages and prices had been mixed in recent months.

Nonfarm payroll employment rose strongly in November after having recorded reduced increases in September and October. Job gains were widespread in November; hiring in the services industries remained brisk, construction payrolls surged further, and retail employment rebounded after a lackluster rise in October. In sharp contrast to the general job picture, employment in manufacturing continued to drop. The civilian unemployment rate fell to 4.4 percent in November.

Total industrial production declined somewhat in November in association with a weather-related drop in utilities output and persisting weakness in mining activity. Manufacturing output was unchanged in November after a considerable increase in October. Production in high-tech industries recorded large gains over the October–November period, the output of construction supplies climbed rapidly, and consumer goods manufacture expanded briskly.

However, production of motor vehicles and parts was unchanged on balance over the two months and materials output continued to decline, with the iron and steel industry registering particularly large decreases. The utilization of manufacturing capacity dropped over the October–November period to its lowest level in more than five years.

Strength in consumer spending persisted in October and November, with retail sales rising sharply in both months. Increases in sales of motor vehicles and other durable goods were particularly large, but expenditures for nondurable goods also recorded sizable advances. Supported by continuing gains in disposable income and the rebound in the stock market, consumer confidence remained at a relatively favorable level, though noticeably below the peak reached earlier in the year.

The residential housing sector continued to surge, as single-family housing starts registered another strong advance in November and sales of new homes remained at a very high level. Unseasonably favorable weather over much of the country evidently contributed to that performance. Nonetheless, the low level of mortgage rates and a record high in an index of consumer assessments of homebuying conditions in November suggested that strength in single-family housing might continue for a time. Multifamily housing starts in October and November were slightly above the average for earlier in the year, and permits for new projects had been rising recently.

Business fixed investment appeared to have rebounded from a small decrease in the third quarter that had been associated in part with a strike-related drop in business purchases of motor vehicles and persisting weakness in nonresidential construction. Shipments of office and computing equipment rose sharply in October after having declined for two months, and a sizable backlog of orders for communications equipment suggested that the downturn in shipments in October after a September surge would be shortlived. In addition, outlays for heavy trucks reached record levels and expenditures for aircraft were well maintained. In the nonresidential sector, building activity remained soft in October. Office construction picked up further in response to falling vacancy rates and rising rental costs, but other building activity continued sluggish, and available data on new contracts pointed to persisting weakness.

Business inventory accumulation slowed appreciably in October after a sizable rise in the third quarter. In manufacturing, however, the pace of stockbuilding picked up in October from a slow rate in the third quarter, and the stock–shipments ratio remained in the upper portion of its narrow range over the past year. In the wholesale sector, inventories declined somewhat in October following a large increase in the third quarter; much of the reduction was in farm products. The inventory–sales ratio for the wholesale sector was still at the top of its range over the past year. Retail inventory accumulation in October was near the modest pace of the third quarter, and the inventory–sales ratio was slightly below its range over the preceding twelve months.

The nominal deficit on U.S. trade in goods and services in October was little changed from its September level but was slightly smaller than its average for the third quarter. The value of exports was up considerably in October from its third-quarter average; the largest gains were in machinery, agricultural products, and industrial supplies. The value of imports also rose in October. The rise in imports was spread across all major trade categories, with the largest increases being in capital goods and oil. The limited information available for the fourth quarter suggested that the Japanese economy remained mired in recession and that the pace of economic growth in most of the other major industrial countries was slowing. Activity in most of the Asian developing economies remained depressed, though there were signs that activity in some was nearing a trough and that growth in China and Taiwan had picked up somewhat. In contrast, economic conditions in most Latin American economies had worsened considerably in recent months.

Consumer price inflation remained subdued in November, with both the overall index and the index excluding food and energy items rising at the same relatively low rates as in October. For the twelve months ended in November, the increase in core consumer prices was a little larger than in the previous twelve-month period, reflecting slightly bigger advances in the prices of both commodities and services. A similar pattern was evident in producer prices of finished goods other than food and energy; core producer prices continued to rise at a low rate in November, and the increase in these prices in the twelve months ended in November was somewhat larger than in the previous twelve-month period. In contrast, prices for crude and intermediate materials continued their downward trend in both the October–November period and the twelve months ended in November. Growth in average hourly earnings of production or nonsupervisory workers had slowed over recent months to a modest rate in October and November. While the deceleration in hourly earnings was relatively widespread across industries, and most pronounced in manufacturing, wages continued to accelerate in the services industries and in finance, insurance, and real estate.

At its meeting on November 17, 1998, the Committee adopted a directive that called for implementing conditions in reserve markets that were consistent with a one-quarter percentage point decrease in the federal funds rate to an average of around 4¾ percent. The Committee also decided that moving to a symmetric directive would be appropriate, given that further easing likely would not be needed over the months ahead unless unexpected developments were to point toward a more substantial weakening in the growth of economic activity or to less inflation than was currently anticipated. The reserve conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over the months ahead.

Open market operations immediately after the meeting were directed toward implementing the desired slight easing in the degree of pressure on reserve positions, and through the remainder of the intermeeting period the Manager sought to maintain that easier stance. The federal funds rate remained very close to its intended lower level on average, and most other short-term market rates registered small mixed changes. Longer-term Treasury rates declined somewhat in response to a weaker outlook for foreign economic activity and the potential damping effect of lower commodity prices on inflation. Share prices in U.S. equity markets remained volatile but posted substantial increases on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar fell slightly over the intermeeting period in relation to other major currencies and also in terms of an index of the currencies of other countries that are important trading partners of the United States. Concerns about the vulnerability of U.S. markets to financial difficulties in

Brazil and uncertainty generated by the impeachment proceedings were said to weigh on the dollar at times. The dollar's larger decline against the Japanese yen than against the German mark and other European currencies may have stemmed from a disparity in interest rate movements in those countries; long-term interest rates rose in Japan, partly in anticipation of heightened financing requirements associated with further fiscal stimulus, while European interest rates fell in response to cuts in official interest rates and weaker-than-expected economic data. Financial conditions affecting emerging market economies continued to improve for a time after the Committee eased monetary policy at its November 17 meeting, but that trend was subsequently reversed after Brazil's legislature decided to reject a key fiscal reform measure.

M2 and M3 had continued to expand rapidly in recent months, although incoming data indicated that growth was slowing somewhat in December. The continued strength of M2 in November reflected the reduction in its opportunity cost as a result of recent easings of monetary policy, greater growth of liquid deposits in association with heavy mortgage refinancing activity, and brisk demand for U.S. currency both at home and abroad. M3 growth was bolstered by further large flows into institution-only money market funds and additional RP financing in association with hefty acquisitions of securities by banks. For the year through November, both aggregates rose at rates well above the Committee's annual ranges. Total domestic nonfinancial debt had expanded in recent months at a pace somewhat above the middle of its range. Continued paydowns of debt by the federal government were more than offset by appreciable growth of private demands for credit to finance strong spending on durable goods, housing, and business investment, as well as merger and acquisition activity.

The staff forecast prepared for this meeting pointed to considerable slowing in the expansion of economic activity in the year ahead to a pace somewhat below the estimated growth of the economy's potential. However, the expansion was expected to pick up later to a rate more in line with that potential. Subdued expansion of foreign economic activity and the lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place continuing, albeit diminishing, restraint on the demand for U.S. exports for some period ahead and to lead to further substitution of imports for domestic products. In addition, growth in private final demand would be restrained to some extent by the tighter terms and conditions that were now being imposed by many types of lenders, by the anticipated waning of positive wealth effects stemming from earlier large increases in equity prices, and by the buildup of stocks of consumer durables, housing units, and business capital goods. Pressures on labor resources were likely to ease slightly as the expansion of economic activity moderated, but inflation was projected to rise noticeably over the year ahead, largely in association with a partial reversal of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic conditions, members commented that moderate growth at a pace close to the economy's potential remained a reasonable expectation for the year ahead. The members recognized, however, that such a projection was subject to an unusually wide range of uncertainty in both directions. On the upside, they emphasized the marked resilience and persisting strength of private domestic demand, which had kept the economy expanding at a faster pace than most had anticipated. In addition, members commented that domestic financial conditions, including the rebound in stock market prices, currently were supportive of further expansion in aggregate demand, and in that regard several noted the continued rapid growth of the broad monetary aggregates. Still, domestic financial markets remained unusually sensitive and subject to relatively pronounced adjustments to unanticipated developments that could have substantial effects on confidence and economic activity. The external sector continued to represent a major source of downside risk; the economies of several industrial countries seemed to be weakening and the outlook for several key emerging market economies remained in doubt, with a further loss of confidence and contagion from the latter a continuing threat. With regard to the outlook for inflation, members reported that labor markets were extraordinarily tight across the nation, but they saw only limited evidence of accelerating wage increases and little or no evidence of rising inflation in broad measures of prices. Several commented, however, that the risks of inflation appeared to be tilted to the upside, given the continuing strength of the domestic expansion and accommodative financial conditions.

In their review of developments in various parts of the country and major industries, members referred to widespread evidence of high levels and strong growth of overall domestic production and demand, but also to the continued retarding effects of the foreign trade sector on agriculture and manufacturing and extractive industries. Growth in consumer spending was expected to moderate over coming quarters from a very robust pace. Factors contributing to this assessment included expectations of somewhat slower growth in employment and incomes and the prospect that increases in financial wealth would moderate or even end at some point. Members also referred to the possibility that the very low saving rate would tend to limit increases in consumer spending, but they noted that high levels of consumer confidence and wealth along with low interest rates should help to sustain at least moderate growth in coming quarters.

Forecasts of business investment spending pointed to appreciable deceleration in the year ahead after very rapid increases in recent years. Among the factors cited in support of a slowing uptrend were the anticipated slower growth in overall demand and the large cumulative buildup of business capital that had resulted in comparatively subdued pressures on capacity. Forecasts of reduced growth in business expenditures tended to be supported by anecdotal reports that many business firms were planning to trim their capital outlays during the year ahead. Perhaps the slower growth in corporate earnings, which had been evident since earlier in the year, and reduced cash flows were beginning to exert some restraint on business capital spending. Some members observed, however, that there was little evidence thus far of any deceleration in business equipment expenditures and that the persistence of tight labor markets should continue to encourage relatively rapid growth in labor-saving business capital.

Housing activity had displayed a great deal of strength in recent months according to both anecdotal and statistical reports at this meeting. Comparatively warm weather had extended the building season in several areas, while rising incomes and low interest rates had continued to stimulate housing demand. Some retrenchment in housing activity from currently high levels seemed likely over coming quarters, given the recent large additions to the stock of housing units and some anticipated deceleration in the growth of jobs and incomes.

Members viewed the foreign sector as likely to exert a smaller negative effect on domestic growth in the year ahead. This view was based on the expectation of some stabilization or improvement in foreign financial markets and economies. In addition, the foreign exchange value of the dollar had been declining in recent months, and the effects of its earlier appreciation on the trade balance would be waning. However, they recognized that net exports could turn out to be substantially more negative than the modal forecast, given the persistence of very fragile financial and economic conditions in several large emerging economies, continued weakness in the Japanese economy, and questions about the prospective strength of economic activity in other industrial nations. As recent experience had demonstrated, a crisis in one or a group of important financial markets and economies could spread rapidly around the world.

The outlook for inflation remained favorable, though some members referred to a number of upside risks going forward. For now, however, there were few signs of rising price inflation despite widespread indications of very tight labor markets, including reports of further tightening in some areas. Indeed, the most recent wage and price data were encouraging. Increases in core measures of prices were limited, and sizable declines in oil and commodity prices should help to moderate inflation going forward, in part by holding down inflation expectations. Looking beyond the nearer term, current forecasts suggested that moderating growth in overall economic activity would tend to limit pressures on resources and foster relatively subdued price inflation in the context of robust productivity growth and ample industrial capacity. Members who viewed the risks as tilted mainly to the upside commented that the effects of the anticipated reversal of a number of factors—including the declines in oil and commodity prices and restrained increases in health care costs—that had tended to hold down overall inflation might turn out to be more pronounced than was currently forecast. Moreover, underlying cost and price pressures might emerge more rapidly under such circumstances, especially if overall demand continued to outpace the growth of potential. Some members also referred to the potential inflationary effects over time of the continuation of quite rapid monetary growth. On balance, however, the members generally believed that prospective trends in overall economic activity and the persistence of strong competitive pressures in most markets, including the effects of foreign competition, were likely in the context of now firmly embedded expectations of low inflation to moderate any tendency for price inflation to accelerate over the year ahead.

In the Committee's discussion of policy for the intermeeting period, all the members agreed on the desirability of maintaining an unchanged policy stance. The System's policy easing actions since late September had helped to stabilize a dangerously eroding financial situation, and current financial conditions as well as underlying economic trends suggested that needed policy adjustments had been completed. For now at least, monetary policy appeared to be consistent with the Committee's objectives of fostering sustained low inflation and high employment. Accordingly, the Committee had entered a period where vigilance was called for but where the direction and timing of the next policy move were uncertain.

As already noted, Committee members saw risks on both sides of their forecasts. Persistently strong demand and increasingly supportive conditions in debt and equity markets suggested the possibility of rising inflation pressures. But greater disturbances abroad, especially if they were to be transmitted to domestic financial markets, could exert considerable restraint on the domestic economy. Fortunately, with low inflation, if not price stability, increasingly embedded in expectations, the Committee would have time to react to potential inflationary pressures. In the event of downward shocks to the expansion, prompt action to ease policy would be needed, but such shocks could not be anticipated at this point. Against this background, all the members indicated that they were in favor of retaining the symmetry in the existing directive.

Before its vote on policy at this meeting, the Committee discussed the wording of the operating paragraph of the directive, building on progress made toward a consensus at previous meetings. Attention focused in part on proposed new wording to describe the possibility of intermeeting actions. There were minor differences about specific wording, but no strongly held opinions, and all the members agreed that the new wording preferred by a majority of the members represented an improvement over the traditional language in that it would communicate more clearly and succinctly the substance of the Committee's policy decisions. The Committee also discussed deleting the last sentence in the operating paragraph relating to the outlook for the growth of money; another paragraph in the directive would continue to report the long-run ranges for such growth that the Federal Reserve Act requires the Committee to establish. With regard to the proposed deletion, some felt it was desirable for the central bank to retain a reference to money in the operating paragraph; more members supported the deletion on the ground that, as had been explained to the Congress, money growth had not had any special significance for some time in the formulation of monetary policy owing to often unexplained and unexpected changes in velocity. The rewording of the sentence on symmetry and the deletion of the sentence on money were not intended to imply any change in policy or the Committee's approach to policy or its decisionmaking.

At the conclusion of the Committee's discussion, all the members supported a reworded directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 4¾ percent and did not contain any bias with respect to the direction of possible adjustments to policy during the intermeeting period.

The Committee then voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that the economy has continued to expand at a brisk pace in recent months. Growth in nonfarm payroll employment was strong in November, after more moderate gains in September and October, and the civilian unemployment rate fell to 4.4 percent. Total industrial production declined somewhat in November, but manufacturing output was stable and up considerably from the third-quarter pace. Business inventory accumulation slowed appreciably in October after a sizable rise in the third quarter. The nominal deficit on U.S. trade in goods and services narrowed slightly in October from its third-quarter average. Total retail sales rose sharply in October and November, and housing starts were strong as well. Available indicators point to a considerable pickup in business capital spending after a lull in the third quarter. Trends in various measures of wages and prices have been mixed in recent months.

Most short-term interest rates have changed little on balance since the meeting on November 17, but longer-term rates have declined somewhat. Share prices in equity markets have remained volatile and have posted sizable gains on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has declined slightly over the period in relation to other major currencies and in terms of an index of the currencies of other countries that are important trading partners of the United States.

M2 and M3 have posted very large increases in recent months. For the year through November, both aggregates rose at rates well above the Committee's annual ranges. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat above the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting on June 30–July 1 the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 4¾ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Votes against this action: None.

Disclosure Policy

The members also discussed various issues relating to the timing and manner of releasing information about the Committee's policy decisions. A range of views was expressed, as at earlier meetings, on the desirability of releasing a statement routinely not only after those meetings at which there was a change in the stance of policy but also after meetings where the Committee altered its view of the direction of possible policy actions during the intermeeting period. Members who favored more announcements believed that such disclosure, by providing more information on the Committee's views of the risks in the economic outlook, generally would allow financial market prices to reflect more accurately the likely future stance of monetary policy. However, other members were concerned that such announcements often would provoke market reactions. As a consequence, the Committee would become less willing to change the symmetry in the directive, and a policy of immediate release might therefore have adverse repercussions on the Committee's decisionmaking. Nonetheless, the members decided to implement the previously stated policy of releasing, on an infrequent basis, an announcement immediately after certain FOMC meetings when the stance of monetary policy remained unchanged. Specifically, the Committee would do so on those occasions when it wanted to communicate to the public a major shift in its views about the balance of risks or the likely direction of future policy. Such announcements would not be made after every change in the symmetry of the directive but only when it seemed important for the public to be aware of an important shift in the members' views. On the basis of experience with such announcements, the Committee would evaluate later whether further changes in its approach to disclosures would be desirable.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, February 2–3, 1999.

The meeting adjourned at 12:55 p.m.

Donald L. Kohn
Secretary