

FEDERAL RESERVE press release



For Use at 4:10 p.m.

October 9, 1981

The Federal Reserve Board and the Federal Open Market Committee today released the attached report of policy actions taken by the Federal Open Market Committee at its meeting on August 18, 1981.

Such records for each meeting of the Committee are made available a few days after the next regularly scheduled meeting and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based solely on the information that was available to the Committee at the time of the meeting.

Attachment

RECORD OF POLICY ACTIONS
OF THE FEDERAL OPEN MARKET COMMITTEE

Meeting held on August 18, 1981

Domestic policy directive

The information reviewed at this meeting suggested that real GNP was likely to change little in the current quarter, following a decline at an annual rate of about 2 percent in the second quarter indicated by preliminary estimates of the Commerce Department. Average prices, as measured by the fixed-weight price index for gross domestic business product, appeared to be continuing to rise less rapidly than earlier in the year.

The dollar value of total retail sales increased appreciably in June and July following sizable declines over the previous two months. Sales gains at dealers in automotive products accounted for about half of the overall increase in June and nearly all of the rise in July. Unit sales of new automobiles picked up somewhat in July from an extremely low pace in the second quarter.

The index of industrial production rose 0.3 percent in July following a slight decline in June. Most of the July increase reflected a continuation of the post-strike rebound in coal output; production of automobiles and trucks fell sharply, and output of construction supplies continued to decline. Capacity utilization in manufacturing edged down to 79.6 percent in July following a more sizable decline in June.

Nonfarm payroll employment, adjusted for changes in the number of workers on strike, advanced substantially in July after having declined

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appreciably in June. Employment gains were widespread, and were relatively strong in manufacturing and in retail trade; employment in construction, however, fell further. The unemployment rate declined to 7.0 percent, somewhat below the average rate of 7.4 percent for the first half of the year.

Private housing starts fell substantially further in June, to an annual rate of just over 1 million units; newly issued permits for residential construction also declined sharply. Combined sales of new and existing homes continued at about the reduced pace of recent months.

The rise in producer prices of finished goods moderated to an annual rate of about 5-1/4 percent in July, a little less than the average in the second quarter and sharply below the rate of 13-1/4 percent in the first quarter. Energy prices declined in July, while prices of finished foods rose sharply. In June, the consumer price index increased at an annual rate of about 8-1/2 percent. As in May, the increase reflected a substantial rise in the homeownership component of the index; retail food prices were about unchanged and though energy prices continued to increase, the pace was much slower than earlier in the year. Over the second quarter as a whole, consumer prices rose at an annual rate of about 7-1/2 percent, compared with a rate of 9-1/2 percent in the first quarter. Over the first seven months of the year, the rise in the index of average hourly earnings was somewhat less rapid than it was during 1980.

In foreign exchange markets the trade-weighted value of the dollar against major foreign currencies had risen about 5 percent further between early July and early August, when it reached its highest level in nearly a decade. More recently, the dollar had declined, but it was up about 2 percent

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on balance over the intermeeting period. In June, the U.S. trade deficit declined slightly from the May level. For the second quarter the deficit was up substantially over the first-quarter rate, as the value of imports increased and the value of exports declined somewhat, reflecting a large drop in agricultural exports.

At its meeting on July 6-7, the Committee had decided that open market operations in the period until this meeting should be directed toward behavior of reserve aggregates associated with growth of M1-B from June to September at an annual rate of 7 percent after allowance for flows into NOW accounts (resulting in growth at an annual rate of about 2 percent from the average in the second quarter to the average in the third quarter), provided that growth of M2 remained around the upper end of its range for the year or tended to move down within the range. If it appeared to the Manager for Domestic Operations that pursuit of the monetary objectives and related reserve paths during the period before the next meeting was likely to be associated with a federal funds rate persistently outside a range of 15 to 21 percent, the Chairman might call for a Committee consultation.

Data becoming available after the first week or so of the intermeeting period indicated some shortfall in growth of M1-B from the short-term path implied by the objective specified by the Committee. Growth of M2 appeared to be about in line with the Committee's objective. Consequently, required reserves and the demand for reserves contracted in relation to the supply being made available through open market operations, and member bank borrowings declined from an average of about \$1-3/4 billion around the time of the July meeting to an average of about \$1.2 billion in the first two statement weeks in August. The federal

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funds rate averaged about 19 percent during July and declined to an average of about 18-1/4 percent during the first half of August. Despite the decline in the federal funds rate, yields on most other short-term instruments rose about 1 to 1-1/2 percentage points over the intermeeting period.

M1-B, adjusted for the estimated effects of shifts into NOW accounts, expanded at an annual rate of about 3-1/2 percent in July, following contraction at annual rates averaging nearly 7 percent in May and June. Growth in M2, buoyed by rapid expansion in money market mutual fund shares, accelerated to an annual rate of 8 percent from an annual rate of about 4 percent on average in the previous two months. In July, the level of shift-adjusted M1-B was well below the lower end of the Committee's range for growth over the year from the fourth quarter of 1980 to the fourth quarter of 1981, while the level of M2 was slightly below the upper end of its range for the year. Data available for early August suggested substantial strength in both M1-B and M2. The strength in M2 apparently reflected in part responses of the public to the availability of more attractive yields on small saver certificates with maturities of 2-1/2 years or more, whose interest rate ceilings were liberalized, effective August 1.

Total credit outstanding at U.S. commercial banks expanded at an annual rate of 5-3/4 percent in July, about the same as in June. With the exception of business loans, which accelerated somewhat further from a brisk pace in June, growth in the major components of bank credit was sluggish. Net issues of commercial paper by nonfinancial corporations expanded at a moderate pace in July, following growth at exceptionally rapid rates in the preceding two months.

Yields on most intermediate- and long-term securities moved up 1/2 to 1-1/2 percentage points over the intermeeting interval to record levels. The

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upward pressure on interest rates apparently reflected increasing concern about current and prospective financing needs of the Treasury in the light of enactment of legislation to reduce taxes, incoming data on the economy that were stronger than many market participants had anticipated, and some disappointment that easing of market pressures had not developed as rapidly as many had expected. The prime rate charged by commercial banks on short-term business loans was raised 1/2 percentage point over the intermeeting period to 20-1/2 percent. In home mortgage markets, average rates on new commitments for fixed-rate loans at savings and loan associations rose to 17-1/4 percent from 16-3/4 percent at the time of the July meeting.

The staff projections presented at this meeting suggested that growth in real GNP probably would be sluggish over the remainder of 1981 and during the first half of 1982. Such a development was likely to be accompanied by a moderate increase in the unemployment rate from its current level. The rise in the fixed-weight price index for gross domestic business product was projected to change little during the rest of this year from the reduced pace of the second quarter but to decline somewhat further in the first half of 1982.

In the Committee's discussion of the economic situation and outlook, the view was expressed that overall economic activity was holding up fairly well despite reports of depressed conditions in some areas of the country and in some credit-dependent sectors of the economy. Real GNP had declined somewhat in the second quarter, but the latest indicators of economic activity did not suggest that a cumulative decline was under way. A number of members emphasized the improvement in key measures of inflation, including

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some signs of moderation in wage increases, and suggested that inflationary expectations might be abating. Other members felt, however, that it was premature to conclude that inflationary attitudes and behavior had been fundamentally altered. In this connection it was observed that restraint on some prices reflected the intense pressures that had built up in financial markets and that a near-term relaxation of those financial pressures might quickly dissipate the sense of progress against inflation.

Several members indicated their broad agreement with the staff projection of little change in economic activity over the months immediately ahead, but one member commented that some decline was a more likely prospect. The longer-run economic outlook was more clouded and subject to diverging influences. Some members were concerned that if abnormally high interest rates should persist for an extended period, the already strong pressures on many interest-sensitive sectors of the economy would intensify and the resulting financial strains could induce dislocations and a sharp decline in overall economic activity. Other members noted that the economy had displayed remarkable resiliency and adaptability to high interest rates and they emphasized that fiscal policy would exert an increasingly stimulative impact on the economy as time went on. It was also suggested that further moderation in inflation would have a favorable effect on economic activity over time, in large part by relieving pressures on financial markets, although the near-term impact could be some reduction in consumer spending that would otherwise have been made in anticipation of later price increases.

At its meeting on July 6-7, 1981, the Committee reaffirmed the monetary growth ranges for the period from the fourth quarter of 1980 to

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the fourth quarter of 1981 that it had set at its meeting in early February. These ranges were 3 to 5-1/2 percent for M1-A and 3-1/2 to 6 percent for M1-B, abstracting from the impact of NOW accounts on a nationwide basis, 6 to 9 percent for M2, and 6-1/2 to 9-1/2 percent for M3. The associated range for bank credit was 6 to 9 percent. The Committee recognized that a shortfall in M1-B growth in the first half of the year partly reflected a shift in public preferences toward other highly liquid assets and that growth in the broader aggregates had been running somewhat above the upper end of the ranges. In light of its desire to maintain moderate growth in money over the balance of the year, the Committee expected that growth in M1-B for the year would be near the lower end of its range. At the same time, growth in the broader monetary aggregates might be at the higher end of their ranges.

In the Committee's discussion of policy for the weeks immediately ahead, a consensus emerged in favor of retaining the monetary growth objectives for the third quarter that had been adopted at the July meeting. There was also agreement to retain the 15 to 21 percent intermeeting range for the federal funds rate that provided a mechanism for initiating further consultation by the Committee. During July, growth in M1-B, adjusted for the estimated effects of flows into NOW accounts, had fallen considerably short of the 7 percent annual rate objective established for the June to September period, and achievement of that objective therefore implied some acceleration of M1-B during August and September. Available data for the first part of August suggested a pickup in M1-B growth, although interpretation was complicated by the transitory influence of demand balances accumulated in conjunction with

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corporate mergers. At the same time, growth in M2, which was already close to the top of its range, also turned up in early August. A staff analysis suggested that the nontransaction components of M2 were likely to continue to expand rather rapidly over the period ahead, partly because of liberalized deposit rate ceilings on small saver certificates.

In the course of the discussion, the members considered at some length the possible implications for the economy, for policy, and for reserve provision of the divergent trends in M1-B and M2, together with the other aggregates. It was emphasized that in addition to the previously recognized distortions in measured growth of M1-B resulting from shifts into NOW accounts and the development of money substitutes, recent legislative and regulatory developments were likely to affect growth in the aggregates, especially M2, over the near term. Among the uncertainties in question were the further impact on M2 of the liberalization of interest rate ceilings on small saver certificates, the continuing attractiveness of money market mutual funds, and the extent to which payments to stockholders as a result of recent merger activities were being invested in nontransaction-type accounts included in M2. Even more difficult to assess was the impact of the introduction of tax-exempt "all saver" certificates on October 1, 1981; those certificates could well contribute to a marked acceleration in M2 growth during the fourth quarter, but in the interim measured M2 might be artificially lowered to the extent that funds earmarked for investment in these new instruments were being temporarily accumulated in repurchase agreements with October 1 maturities.

Given the uncertainties that were involved, the members agreed that widely divergent behavior of the aggregates might pose difficult questions

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about policy implementation and reserve provision over the coming period. A view was also expressed that the increasing difficulty of interpreting the performance of the monetary aggregates argued for giving weight to interest rates in evaluating the degree of restraint being exerted by monetary policy. This view was based on the premise that interest rates were already exerting a great deal of restraint and a small decline would be welcomed, provided it was not inconsistent with achievement of the Committee's longer-term objectives for monetary growth. In contrast, the danger was emphasized that a change in approach that attempted to stabilize interest rates or to encourage a near-term decline could well be counterproductive if such an effort were accompanied by or fostered an excessive rebound in monetary growth; the net result could then be to encourage inflationary expectations, call into question the commitment of the Federal Reserve to an anti-inflationary policy, and thereby actually jeopardize the prospects for ultimately achieving and sustaining the significantly lower interest rates that were sought.

Several members expressed concern about placing too much reliance on M2 as a guide to policy over the weeks ahead in light of the various factors that were potential sources of distortion. In this view the provision of reserves should not be restrained solely on the basis of M2 growth in excess of the Committee's objective. In the discussion, it was understood that the sizable growth in M2 in prospect for August would not in itself call for further restraint in the provision of reserves, since such growth would, in any event, leave M2 around the upper end of its range for the year as provided in the directive. Should measured growth subsequently appear excessive in the light of the target, careful assessment would be required of the possibility that special factors, including regulatory and institutional changes,

were distorting the data. If necessary, the Chairman might call for Committee consultation to evaluate the implications for policy.

At the conclusion of the discussion, the Committee agreed to reaffirm the short-run policy objectives for the third quarter adopted at its previous meeting.

The following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests little change in real GNP in the current quarter, following a small decline in the second quarter; prices on the average appeared to be continuing to rise less rapidly than earlier in the year. The dollar value of total retail sales increased appreciably further in July, reflecting some recovery in sales at automotive dealers. Industrial production rose slightly in July, while nonfarm payroll employment advanced substantially; the unemployment rate declined to 7.0 percent, somewhat below its average level in earlier months of 1981. In June housing starts declined sharply further. Over the first seven months of the year, the rise in the index of average hourly earnings was somewhat less rapid than during 1980.

The weighted average value of the dollar rose further against major foreign currencies in July and early August, registering gains against all major currencies. In June the U.S. foreign trade deficit declined slightly from the May level, but for the second quarter the deficit was up substantially over the first-quarter rate.

In July M1-B, adjusted for the estimated effects of shifts into NOW accounts, expanded somewhat following a substantial decline in May and June, and growth in M2 accelerated from a relatively sluggish pace in the previous two months. The level of adjusted M1-B in July was well below the lower end of the Committee's range for growth over the year from the fourth quarter of 1980 to the fourth quarter of 1981 while the level of M2 was slightly below the upper end of its range for the year. Available data for early August suggested further acceleration in growth of M1-B and M2, with acceleration in M2 apparently influenced in part by

initial responses of the public to the availability of more attractive deposit instruments, pointing up the necessity of evaluating the behavior of M2 in the light of the impact of regulatory and legislative changes. Since early July most market interest rates have risen considerably on balance.

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation, promote sustained economic growth, and contribute to a sustainable pattern of international transactions. At its meeting in early July, the Committee agreed that these objectives would be furthered by reaffirming the monetary growth ranges for the period from the fourth quarter of 1980 to the fourth quarter of 1981 that it had set at the February meeting. These ranges included growth of 3-1/2 to 6 percent for M1-B, abstracting from the impact of flows into NOW accounts on a nationwide basis, and growth of 6 to 9 percent and 6-1/2 to 9-1/2 percent for M2 and M3, respectively. The Committee recognized that the shortfall in M1-B growth in the first half of the year partly reflected a shift in public preferences toward other highly liquid assets and that growth in the broader aggregates had been running at about or somewhat above the upper ends of their ranges. In light of its desire to maintain moderate growth in money over the balance of the year, the Committee expected that growth in M1-B for the year would be near the lower end of its range. At the same time, growth in the broader aggregates might be high in their ranges. The associated range for bank credit was 6 to 9 percent. The Committee also tentatively agreed that for the period from the fourth quarter of 1981 to the fourth quarter of 1982 growth of M1, M2, and M3 within ranges of 2-1/2 to 5-1/2 percent, 6 to 9 percent, and 6-1/2 to 9-1/2 percent would be appropriate. These ranges will be re-considered as warranted to take account of developing experience with public preferences for NOW and similar accounts as well as changing economic and financial conditions.

In the short run the Committee continues to seek behavior of reserve aggregates consistent with growth of M1-B from June to September at an annual rate of 7 percent after allowance for the impact of flows into NOW accounts (resulting in growth at an annual rate of about 2 percent from the average in the second quarter to the average in the third quarter), provided that growth of M2 remains around the upper limit of, or moves within, its range for the year. It is recognized that shifts into NOW accounts will continue to distort measured growth in M1-B to an unpredictable extent, and

operational reserve paths will be developed in the light of evaluation of those distortions. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that pursuit of the monetary objectives and related reserve paths during the period before the next meeting is likely to be associated with a federal funds rate persistently outside a range of 15 to 21 percent.

Votes for this action: Messrs. Volcker, Solomon, Boykin, Corrigan, Gramley, Keehn, Rice, Schultz, Mrs. Teeters, Messrs. Wallich and Black. Vote against this action: Mr. Partee. (Mr. Black voted as alternate for Mr. Boehne.)

Mr. Partee dissented from this action because, as at the previous meeting, he preferred to give more emphasis to reducing the risk of a cumulative decline in growth of M1-B in light of the indications of weakening in economic activity. Accordingly, he favored specification of a somewhat higher objective for growth of M1-B over the period from June to September, and without the additional weight assigned to the potential for more rapid growth of M2. In his view, the short-run behavior of M2 was subject to great uncertainty because of the volatile influence of money market mutual funds, the liberalization of deposit rate ceilings on small saver certificates beginning August 1, and the introduction of tax-exempt "all saver" certificates beginning October 1.