

FEDERAL RESERVE press release



For Use at 4:30 p.m.

October 4, 1985

The Federal Reserve Board and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on August 20, 1985.

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

Attachment

RECORD OF POLICY ACTIONS OF THE
FEDERAL OPEN MARKET COMMITTEE

Meeting held on August 20, 1985

Domestic policy directive

The information reviewed at this meeting suggested that economic activity was probably expanding in the current quarter at a moderately faster pace than in the first half of the year. Broad measures of prices and wages continued to indicate that inflation was running at about the same pace as in 1984.

The index of industrial production rose 0.2 percent in July, about the same increase as in each of the preceding two months. Output of consumer goods was relatively strong, reflecting gains in the production of automobiles and home goods. Production of construction supplies and of materials also increased in July; but production of business equipment fell, and output of defense and space equipment declined after several months of extraordinarily rapid growth. Capacity utilization for total industry was 80.8 percent in July, unchanged since April and 1.2 percentage points below its year-earlier level.

Total nonfarm payroll employment rose 240,000 in July, a little above the average monthly increase during the first half of the year. Job gains remained uneven across industries, as employment in manufacturing declined slightly further while employment in service-producing industries continued to account for the bulk of the advance. The civilian unemployment rate remained at 7.3 percent in July, unchanged since February.

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The nominal value of retail sales increased 0.4 percent in July after two months of decline. Sales of general merchandise recovered somewhat after falling in May and June, and sales of furniture and appliances rose at about the average pace of the preceding two months. In the automotive sector, however, sales of domestic automobiles dropped to an annual rate of 7-1/2 million units--1 million below the average level earlier in the year when foreign cars were in short supply and financing incentive programs for domestic cars were prevalent. Sales slipped still further in early August to an annual rate of around 7 million units, with some of the slowing perhaps attributable to the recent strike by auto-haulers. The tentative settlement of that strike and the reintroduction of below-market-rate financing programs pointed to a likely rebound in sales of domestically produced autos.

Total private housing starts fell slightly in July to an annual rate of 1.65 million units. The lower pace reflected a drop in starts of multifamily units, as starts of single-family structures edged higher. Other indicators suggested some pickup in construction activity in the near term: newly issued permits for residential building remained at a high level relative to starts, consumer attitudes toward buying houses were quite positive, and informal trade reports from homebuilders indicated heightened buyer interest and sales activity.

Trends in business capital spending have been obscured lately by extreme volatility in monthly data, but available information suggested further growth over the period ahead, though probably at a relatively modest pace, following the extraordinarily rapid growth earlier in the economic

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expansion. In June, the latest month for which data on business investment were available, new orders and shipments of nondefense capital goods rebounded. On the other hand, outlays for nonresidential construction weakened.

The producer price index for finished goods rose 0.3 percent in July, after declining 0.2 percent in June. The rise in July reflected in part a surge in prices of fresh vegetables that boosted the index for finished foods 1.3 percent; other food prices generally declined, however, and prices of crude foods fell in July for the seventh consecutive month. The consumer price index rose 0.2 percent in June, the same as in May. Food prices changed little over the two-month period and consumer commodity prices declined, but service prices continued to rise at a comparatively rapid rate. Thus far in 1985, producer and consumer prices and the index of average hourly earnings had risen at rates close to those recorded in 1984.

Since the Committee's meeting in July, the trade-weighted value of the dollar against major foreign currencies had fallen nearly 4-3/4 percent further, to a level about 17 percent below its peak in late February. Most of the recent decline was in the early part of the intermeeting period; since late July the dollar's value had declined only slightly further on balance. The U.S. merchandise trade deficit widened in the second quarter to a record annual rate of nearly \$134 billion. Both agricultural and non-agricultural exports fell substantially, while imports registered a small increase. The rise in imports was attributable to a substantial increase in the volume of oil imports after a sharp decline in the first quarter.

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At its meeting on July 9-10, 1985, the Committee had adopted a directive that called for maintaining the existing degree of pressures on reserve positions, keeping in mind the possibility of some increase in those pressures if growth of the monetary aggregates exceeded intentions. That action was expected to be consistent with growth of both M2 and M3 at an annual rate of around 7-1/2 percent for the period from June to September. Over the same period the expansion of M1 was expected to slow substantially to an annual rate of 5 to 6 percent. The members agreed that somewhat lesser restraint on reserve positions might be acceptable in the event of growth in the monetary aggregates that was substantially slower than expected while somewhat greater restraint would be acceptable if monetary growth were substantially faster. In either case, adjustments in the degree of reserve pressures would be considered against the background of developments relating to the strength of the business expansion, progress against inflation, and conditions in domestic credit and foreign exchange markets. The intermeeting range for the federal funds rate was retained at 6 to 10 percent.

Though slowing from the quite rapid May-June pace, M1 had shown relatively strong growth since midyear; it increased at an annual rate of about 9 percent in July and data for early August indicated the likelihood of stronger growth in the current month. Thus, its expansion appeared to be well above the Committee's expectations for the June-to-September period. The strength in M1 reflected an acceleration in other checkable deposits while demand deposits, though increasing little on balance, remained at high levels as the extraordinary surge of late spring in such deposits

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showed no signs of unwinding. Expansion in the broader aggregates slowed in July from the average pace over the previous two months, to annual rates of about 8-1/2 percent for M2 and 4-1/4 percent for M3. For the period from the fourth quarter of 1984 through July, growth in M2 was around the upper end of its range for 1985, while the recent sluggish growth in M3 had brought its growth to around the midpoint of its range. Expansion in total domestic nonfinancial debt remained high relative to the Committee's monitoring range for the year.

Early in the intermeeting interval open market operations were directed at maintaining the existing degree of pressures on reserves. By early August, with M1 running well above the Committee's expectations at the time of the July meeting, and with M2 also on the high side, against the background of a weaker dollar and sustained economic activity, desk operations were conducted with a view toward more cautious provision of reserves. The level of adjustment plus seasonal borrowing, which had been artificially high around the time of the July meeting because of seasonal strains associated with the midyear statement date and July 4 holiday period, averaged about \$410 million in the two-week maintenance period ending July 31 and rose to \$480 million in the first half of August.

The weekly average federal funds rate was generally in the 7-3/4 to 7-7/8 percent area during the intermeeting interval, though average daily rates ranged from about 7-3/8 percent to as high as 8-3/4 percent. Most other short-term interest rates rose about 20 to 45 basis points over the intermeeting interval, mainly reflecting a reassessment by market participants of the outlook for the economy and for monetary policy. Yields on intermediate- and long-term Treasury securities increased about 20 to 30

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basis points, while yields on corporate bonds generally rose somewhat more. The average contract rate on new commitments for fixed-rate conventional home mortgage loans moved up slightly to around 12-1/4 percent.

The staff projections presented at this meeting suggested that growth in real GNP would pick up somewhat in the second half of the year from the sluggish pace in the first half, and would continue at a modest pace through 1986. Although domestic final demand was projected to rise less rapidly than earlier this year, a larger share of the increase was expected to be met out of domestic production rather than from imports or reduced inventory investment. The unemployment rate was projected to edge down only slightly over the forecast horizon and the rate of increase in prices was projected to remain close to that experienced in recent years.

In the Committee's discussion of the economic situation and outlook, the members focused on various uncertainties and risks inherent in current economic and financial conditions. They noted with some concern the absence of clear evidence that business activity might be strengthening, as they had expected earlier, following sluggish growth during the first half of 1985. Nonetheless, with domestic final demands remaining relatively buoyant, most of the members agreed that some pickup in the rate of economic expansion continued to be a reasonable expectation for the second half of the year. They recognized that various imbalances and financial strains in the economy constituted ongoing threats to the economic expansion and raised the danger that growth would be more sluggish than anticipated. Some members also observed that unexpected developments stemming from domestic or international financial problems or from other difficulties in specific sectors of the

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economy, if not contained, could interrupt the expansion itself. On the other hand, a few members remained relatively optimistic about the prospective performance of the economy; it was also suggested that the rapid growth in M1 in recent months might well lead with some lag to faster economic expansion than was currently anticipated.

Particular emphasis was given during the Committee's discussion to the prospect that domestic economic developments would depend importantly on international conditions, including the economic performance of industrialized countries, the ability and willingness of developing countries to manage their foreign debt problems, the global energy situation, and the foreign exchange value of the dollar. The members continued to stress, as they had at previous meetings, the strongly adverse impact that foreign competition, fostered by a high value of the dollar in foreign exchange markets, was having on overall domestic economic activity and in particular on many manufacturing firms and on agriculture. Some members commented that the prospects for near-term improvement in the balance of trade seemed to be relatively remote.

While a further decline in the dollar would tend with some lag to have a favorable impact on the balance of trade, a sense of "free fall" in the dollar would represent a major threat to progress toward price stability and to interest rates. In general, while a decline over time would not be disturbing, it was viewed as important to maintain a certain confidence in the dollar, given the large net inflows of funds from abroad needed to bridge the gap between the relatively limited availability of domestic saving and the funds required to finance the federal budget deficit and private capital

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outlays. Without provision of such funds relatively willingly from abroad, pressures on domestic interest rates would be greater than otherwise. The members agreed that the transition to a lower trade deficit and a more sustainable pattern of international transactions generally, presumably accompanied by a lower dollar, would be greatly facilitated by substantial progress in reducing future deficits in the federal budget and by the avoidance of protectionist legislation that could have a highly unfavorable effect on international trade, on the ability of developing countries to resolve their external debt problems, and on the overall performance of the domestic economy. Several members noted that the risks associated with the underlying distortions and problems in the domestic economy and the persisting strains in domestic and international financial markets posed dilemmas that were not amenable to a monetary policy solution.

As they had at earlier meetings, the members commented on the uneven pattern of developments in various sectors of the economy. They gave special emphasis to the problems in agriculture but also cited other problem or lagging areas of the economy. In most parts of the country, however, strength in a number of industries such as services and defense production currently tended to outweigh the economic weaknesses. In the construction area, one member called attention to recent indications of reduced nonresidential building activity and other members commented that vacancy rates in office structures were relatively high in several parts of the country. On the other hand, there were reports of growing buyer interest in housing, although recent data on housing starts were weaker than expected. With regard to financial conditions, a number of members referred to various financial practices and the buildup or incautious use of debt that had rendered many borrowers and their lenders more vulnerable

to economic adversity. In the case of consumers, rising debt burdens together with the possibility of reduced income growth were viewed by at least some members as likely to restrain expansion in consumer expenditures.

At its meeting in July the Committee had reviewed the basic policy objectives that it had established in February for growth of the monetary and credit aggregates in 1985 and had set tentative objectives for expansion in 1986. For the period from the fourth quarter of 1984 to the fourth quarter of 1985, the Committee had reaffirmed the ranges for the broader aggregates set in February of 6 to 9 percent for M2 and 6 to 9-1/2 percent for M3. The associated range for total domestic nonfinancial debt was also reaffirmed at 9 to 12 percent for 1985. With respect to M1, the base was moved forward to the second quarter of 1985 and a range of 3 to 8 percent at an annual growth rate was established for the period to the fourth quarter of the year. For 1986 the Committee agreed on tentative monetary growth objectives that included reductions of 1 percentage point in the upper end of the M1 range and 1/2 percentage point in the upper end of the M3 range. The provisional range for total domestic nonfinancial debt was reduced by 1 percentage point for 1986.

In the Committee's discussion of policy implementation for the weeks immediately ahead, the members took particular account of the disparate behavior of M1 and the economy. Under the circumstances, a consensus emerged against making a substantial change for the time being in the degree of reserve restraint that had been sought recently. The members recognized that the behavior of M1 was subject to unpredictable fluctuations. Nonetheless, they continued to expect that the expansion in M1 would moderate appreciably over the months ahead, if something like the current degree of restraint on reserve positions was maintained.

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In the course of the Committee's discussion, a number of members emphasized the uncertainties surrounding the behavior of M1 and the downside risks they saw in the economy. Under prevailing circumstances, the surge in M1 growth might not have the usual inflationary implications. The demand for assets in M1 appeared to have been influenced by the relatively low level of interest rates on market instruments and also on small time certificates of deposits, and the velocity of money seemed to be continuing to decline sharply. Moreover, there had been no signs of increasing price pressures in aggregate price indicators or in commodity markets. It was also argued that the objective of achieving M1 growth within the Committee's long-run range might receive somewhat reduced emphasis, at least for a time, pending evaluation of further developments including the performance of the broader aggregates.

Other members expressed more concern that further M1 growth at rates substantially above the Committee's long-run range would have inflationary consequences over time. They noted the persisting strength of M1 in recent weeks, and should that continue, they felt that added reserve restraint would probably be desirable to bring M1 closer to the upper end, or within, the Committee's long-run range by the fourth quarter. Continued strength in M1 could also raise questions about the Committee's commitment to an anti-inflationary policy, with potentially adverse implications for inflationary expectations. Some members also commented that the rapid growth in M1 had already built up considerable liquidity that would tend to sustain the expansion over the months ahead.

While there were shadings of opinion with regard to the appropriate degree of reserve pressure under the circumstances, on balance a majority of the members indicated their acceptance of a directive that called for maintaining the slightly firmer degree of reserve restraint that had been sought in recent weeks. The members expected such an approach to policy implementation to be consistent with growth of M2 and M3 at annual rates of around 8-1/2 and 6-1/2 percent respectively for the period from June to September, not much changed from expectations at the time of the July meeting. Growth in M1 was expected to slow from its recent pace, but given the rapid expansion since June, M1 was now anticipated to grow at an annual rate of about 8 to 9 percent over the three-month period, considerably above earlier expectations. Two members argued for immediate adjustments in the degree of reserve pressures -- although in opposing directions -- based on their differing evaluations of the significance of recent monetary growth for inflation and economic activity as against the risks to sustained expansion stemming from the financial vulnerabilities and the underlying imbalances in the economy.

In keeping with the Committee's usual practice, the members contemplated the possible need for some intermeeting adjustment in the degree of reserve restraint. They agreed that somewhat greater restraint on reserve positions would be acceptable if growth in the monetary aggregates were substantially faster than expected, while somewhat lesser restraint would be acceptable if monetary growth were substantially slower. As in the past, any such adjustment should not be made automatically in response to the behavior of the monetary aggregates alone, but should take broader economic and financial developments into account, including conditions in domestic

and international financial markets. For the period ahead, several members believed that policy implementation should be especially alert to developments in the foreign exchange markets. The members agreed that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 6 to 10 percent.

At the conclusion of the meeting, the following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that economic activity is probably expanding in the current quarter at a moderately faster rate than in the first half of the year. In July, industrial production continued to move somewhat higher and total retail sales rose modestly after two months of decline. On the other hand, housing starts fell somewhat in July. Information on business capital spending suggests further growth, though at a much less rapid pace than earlier in the economic expansion. Total nonfarm payroll employment continued to increase in July, although employment in manufacturing declined slightly further. The civilian unemployment rate remained at 7.3 percent in July, unchanged since February. Broad measures of prices and wages appear to be rising at rates close to those recorded in 1984.

Since the Committee's meeting in July, the trade-weighted value of the dollar against major foreign currencies has depreciated further. The merchandise trade deficit widened in the second quarter to the highest rate on record. Both agricultural and non-agricultural exports fell substantially, while imports registered a small increase.

Based on data for July and early August, M1 has been growing relatively rapidly. Demand deposits have shown little change on balance, but other checkable deposits have expanded substantially. Growth in M2 has continued at around the upper end of its 1985

range, while relatively sluggish growth in M3 recently has brought this aggregate to the midpoint of its range. Expansion in total domestic nonfinancial debt has remained high relative to the Committee's monitoring range for the year. Most interest rates have risen somewhat since the July meeting of the Committee.

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

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

the Committee also recognized that account would need to be taken of experience with institutional and depositor behavior in response to the completion of deposit rate deregulation early in the year.

In the implementation of policy for the immediate future, the Committee seeks to maintain the degree of pressure on reserve positions sought in recent weeks. This action is expected to be consistent with growth in M2 and M3 at annual rates of around 8-1/2 and 6-1/2 percent, respectively, during the period from June to September. M1 growth is expected to slow from its recent pace, but given the rapid growth in recent weeks, expansion over the June-to-September period may be at an 8 to 9 percent annual rate. Somewhat greater restraint would be acceptable in the event of substantially higher growth in the monetary aggregates. Somewhat lesser restraint would be acceptable in the event of substantially slower growth. In either case such a change would be considered in the context of appraisals of the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that 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 6 to 10 percent.

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

Mr. Black dissented because he preferred to direct open market operations promptly toward a somewhat greater degree of reserve restraint and thereby improve the prospects of moderating M1 growth to within the Committee's range for the second half of the year. Ms. Seger dissented because she favored some reduction in the degree of reserve restraint in light of the financial vulnerability of some sectors of the economy and in order to encourage sustained economic expansion.

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At a telephone consultation on September 23, the Committee discussed the possible implications for intervention in foreign exchange markets of the deliberations during the weekend of the Ministers of Finance and Central Bank Governors of the G-5 countries. In the course of discussion, it was indicated that the likely potential for U.S. sales of dollars and acquisitions of foreign currencies over the near term fell generally within existing Committee authorizations.