

# FEDERAL RESERVE press release



For Use at 4:30 p.m.

October 4, 1991

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, 1991.

The record for each meeting of the Committee is made available a few days after the next regularly scheduled meeting and subsequently is published in the Federal Reserve Bulletin and the Board's Annual Report. The summary description of economic and financial conditions contained in each record is 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, 1991

The information reviewed at this meeting was mixed, but it suggested on balance that economic activity was expanding at a moderate pace. Some strengthening in consumption expenditures, notably for motor vehicles, and in single-family residential investment was providing much of the impetus for the recovery. On the other hand, business fixed investment was still weak, and the runoff of business inventories was showing few signs of abating. On the supply side, production had strengthened, particularly in manufacturing and housing, but labor demand remained soft overall. Increases in consumer prices had been small in recent months, while the pace of labor cost increases did not appear to have slowed further.

Total nonfarm payroll employment edged down in July, but substantial upward revisions to data for May and June left the July level above that for April. Job gains were recorded in manufacturing, retail trade, and health services in July, but employment in construction and various financial service industries continued to contract. Despite the lower employment level and a sharp decline in the average workweek, the unemployment rate fell slightly to 6.8 percent in July apparently owing to a net exit of jobless workers from the labor force.

Led by another rise in the production of motor vehicles, industrial production rose appreciably further in July, although the rate of increase was a little less than the average pace in the second quarter. Over the period from April through July, production retraced nearly half of the decline that had occurred between September of last year and March. Total industrial capacity utilization rose for a

fourth consecutive month in July, but the overall operating rate was still well below its longer-run average.

Retail sales rose in July, and previously reported increases for May and June were revised upward. Gains at automotive dealers remained strong, and sales at general merchandise, apparel, and furniture outlets in July more than retraced a sharp June decline. Housing starts continued to trend higher in July. As had been the case thus far in the upturn, most of the July increase occurred in single-family units; multifamily starts edged up but remained near the 30-year low recorded in May. Sales of both new and existing homes strengthened further in June.

Business fixed investment declined again in the second quarter as outlays for producers durable equipment fell modestly, and forward-looking indicators pointed to sluggishness in spending for equipment over the near term. Reflecting in part the damping effect on office construction of high vacancy rates and falling property values for existing buildings, the decline in nonresidential construction continued in the second quarter, and data on construction permits and contracts suggested that this sector likely would remain weak for an extended period. Inventory liquidation by manufacturers and non-auto trade establishments continued through the second quarter, although the pace slowed in June from the sharp declines of April and May. The ratio of stocks-to-sales at these establishments was about unchanged.

The nominal U.S. merchandise trade deficit narrowed somewhat in June from the downward revised May value and was somewhat below its rate for the first quarter. For the second quarter, there was substantial growth in the value of exports, primarily resulting from strength in machinery, commercial aircraft, and automotive products.

The value of imports edged up as increases in foods and selected capital goods were not quite offset by declines in oil and automotive products. Economic activity in the major foreign industrial countries continued to present a mixed picture. Tentative signs of more rapid growth emerged in the second quarter in some European countries, but the pace of economic activity appeared to have eased in Japan and Germany from robust rates in the first quarter.

Declines in the prices of food and energy in June and July damped the rise in consumer prices and lowered producer prices of finished goods. Excluding food and energy items, consumer prices rose over the twelve months ended in July at a slightly slower rate than in the preceding twelve months. At the producer level, prices of nonfood, non-energy items continued to increase in July at the very slow second-quarter pace. Total compensation per hour for private industry workers accelerated a bit in the second quarter, reflecting the effects of a sharp increase in the cost of benefits and the upward adjustment of the minimum wage in April.

At its meeting on July 2-3, 1991, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions and that did not include a presumption about the likely direction of any intermeeting adjustments to policy. Accordingly, the Committee decided that somewhat greater or somewhat lesser reserve restraint might be acceptable during the intermeeting period ahead depending on progress toward price stability, trends in economic activity, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets. The reserve conditions contemplated at this meeting were expected to be consistent with some increase in the growth of M2 and M3 to annual rates of

around 5-1/2 and 3 percent respectively over the three-month period from June through September.

Open market operations during the intermeeting period initially were directed toward maintaining the existing degree of pressure on reserve positions. Subsequently, in early August, reserve pressures were eased slightly; this action was taken against a backdrop of indications that price pressures were abating and the recovery was proving to be sluggish at a time of persisting weakness in the broad monetary aggregates. Over the course of the period, two technical increases were made to expected levels of adjustment plus seasonal borrowing to reflect the run-up in seasonal borrowing that usually occurs at this time of the year. In the three reserve maintenance periods completed since the July meeting, adjustment plus seasonal borrowing tended to run at appreciably higher levels than expected, owing in part to difficulties in estimating nonborrowed reserve needs near the ends of reserve maintenance periods. The federal funds rate averaged around 5-3/4 percent in the early part of the intermeeting period, but following the action to ease reserve conditions, the rate averaged about 5-1/2 percent.

Other market interest rates declined appreciably over the intermeeting period in response to downward revisions in market expectations about the pace of the recovery and price pressures, the easing of reserve conditions, and especially for short-term Treasury securities, the uncertain outcome of the coup attempt in the Soviet Union that had begun a few days before the meeting. Despite the uncertainty surrounding the status of the recovery, interest rates on private instruments fell as much as Treasury yields, and most major indexes of stock market prices advanced considerably. Expectations of a slower recovery and an easier monetary policy in the United States

contributed to a decline on balance in the trade-weighted value of the dollar in terms of the other G-10 currencies over the intermeeting period. Late in the period, the coup attempt in the Soviet Union triggered a sharp rise in the dollar against many European currencies.

The broad monetary aggregates were quite weak in July. After several months of sluggish growth, M2 contracted as expansion in transaction deposits slowed and retail time deposits continued to run off at a rapid rate. M3 fell further in July as declines in M2 were augmented by further runoffs of large time deposits. The reasons for the weaker-than-expected growth of the broader aggregates were not entirely understood; however, it appeared that the underlying weakness in credit growth at depository institutions combined with shifts of funds out of the broader aggregates by depositors reaching for higher yields were contributing to the reduced growth. For the year through July, M2 and M3 had expanded at rates near the lower ends of the Committee's ranges.

The staff projection prepared for this meeting indicated that the economy was continuing to recover from the recent recession, although somewhat slower growth than previously anticipated was now projected for the second half of the year. The projection still pointed to moderate expansion in final demand over the next several quarters, with economic activity later this year and in the first part of 1992 given added impetus by a cyclical swing from substantial liquidation to modest accumulation in business inventories. The stimulus from the swing in inventories was expected to diminish during the first part of next year, but business capital expenditures were projected to pick up as the recovery continued. Real purchases of goods and services by the federal government were projected to trend downward, and budgetary problems were expected to restrain spending by

state and local governments. On balance, the expansion in economic activity was projected to be relatively moderate in comparison with past cyclical experience. Persisting though diminishing slack in the economy was expected to induce a further moderation in cost pressures and an appreciable decline in the core rate of inflation over the period through 1992.

In the Committee's discussion of current and prospective economic and financial conditions, the members generally agreed that the recovery was continuing, although recent economic data and the general tenor of the anecdotal information suggested an uneven performance in different sectors of the economy and parts of the country. While sustained expansion at a moderate pace was still viewed as a reasonable expectation, many members now believed that the risks were tilted toward the downside. These risks stemmed to an important extent from the financial side of the economy: life insurance companies as well as banks had become quite cautious lenders, and the very weak recent data on both money and credit added to concerns about financial developments. In addition, consumer surveys and business contacts suggested some erosion in the confidence that had built up amid the initial signs of an economic turnaround after the end of the Persian Gulf war. Some members commented, however, that the prospective sources and potential strength of the expansion were always difficult to discern at this stage of the recovery, and a stronger-than-projected expansion could not be ruled out. With regard to the outlook for inflation, members continued to anticipate a reduction in its core rate over coming quarters, especially following an extended period of restrained monetary growth. However, several expressed disappointment regarding the recent behavior of labor costs and commented that progress toward lower inflation might be more

limited, at least in the quarters immediately ahead, than they had expected earlier.

Recent events in the Soviet Union had introduced a new element of uncertainty in the economic outlook. The outcome of the coup attempt was uncertain, but should it succeed early market reactions suggested the possibility of some adverse consequences for the U.S. economy stemming in part from a further deterioration in business and consumer confidence, an increase in the price of oil and an appreciation in the dollar, and perhaps higher long-term interest rates.

The financial sector of the domestic economy continued to be seen as a potential source of developments that could hold the expansion below the forecast. Financing from a number of institutional lenders had been curtailed for some time and did not yet show signs of becoming more readily available; indeed, mounting difficulties for some life insurance companies could reduce further the willingness of these lenders to extend credit. Members also commented that the continuing publicity given to the weakened condition of many financial institutions along with widespread reports of financial scandals tended to erode confidence. Several observed that the weakness of the monetary aggregates, while not closely correlated with short-run economic performance, was nonetheless a matter of increasing concern to the extent that it implied unusual constraints on the availability of credit and possibly a faltering economic expansion. On the positive side, the financial condition of banking institutions appeared to be continuing to stabilize or improve. Indeed, while banks had raised their credit standards, bank financing was widely reported to be readily available to credit-worthy borrowers, at least outside the real estate sector, though bank lending continued to lag

because of weak credit demand associated in part with inventory liquidation and because many business firms were taking advantage of their direct access to financial markets. In the absence of further deterioration in lender confidence, the availability of loans from financial intermediaries could be expected to increase over time and appeared likely to be adequate to finance a moderate recovery. Nonetheless, the risks seemed to be skewed toward the possibility of further difficulties damping credit supplies and impeding economic growth.

In the course of their discussion, members commented on continuing indications of mixed business conditions in different parts of the country. They noted that economic activity appeared to have deteriorated at least marginally in several regions, though the available evidence pointed on the whole to growth in the overall economy. Members referred to the contrast between gloomier business attitudes and the improvement that was occurring in some sectors of the economy, notably industrial production and housing. Business executives seemed disappointed by a much less vigorous rebound in demand than they had anticipated with the end of the Persian Gulf war. In the circumstances, they remained very cautious in managing their inventories and reluctant to undertake major investment projects.

Available information suggested that inventories had declined somewhat further in recent months. As at previous meetings, members anticipated that with inventories at much reduced levels, the pickup in final demand would at some point stimulate a turnaround in inventory investment that would in turn provide an important fillip to the expansion. Thus far, however, the evidence did not indicate a cumulative expansionary process involving stepped-up inventory demand that generated growth in production, incomes, and spending and in turn

stimulated further demand for inventories. Some members commented that the relative weakness in commodity prices was further evidence that a self-reinforcing process of that kind had not yet emerged in the current cyclical recovery. There was little reason to conclude, however, that a dynamic process of that sort, which in the early stages of past cyclical recoveries had tended to provide the major thrust to the expansion, would fail to materialize in the quarters ahead.

During their discussion, members commented that retail sales appeared to be improving at least a little in many parts of the country but remained quite sluggish elsewhere. An important but geographically uneven source of strength was the sale of motor vehicles, though contacts in the auto industry suggested some disappointment over the sales performance of many new models. In general, consumers remained concerned about financial developments, relatively heavy debt burdens, and uncertainty about employment prospects. While further growth in consumer spending was a likely development, various factors tending to inhibit consumer confidence and an already low saving rate pointed to relatively limited expansion in such spending over the quarters ahead.

Members did not see business capital spending as an important source of stimulus to the economy over the next few quarters. There were continuing reports of marked weakness in commercial construction activity, reflecting the persistence of high vacancy rates in many parts of the country that were likely to hold back new building for an extended period. Nonetheless, overall nonresidential construction appeared to have bottomed out in some areas and indeed to have edged up in others, buttressed by expenditures on public works projects by a number of state and local governments. Current spending

for business equipment was less depressed though also indicative of considerable caution on the part of businessmen in the context of disappointing profits and uncertain demand for their products. While a pickup in equipment spending could be expected to occur with some lag during the course of the cyclical upswing, overall capital spending was likely to grow at a relatively subdued pace unless final demand turned out to be much stronger than the members currently expected and induced a major turnaround in business sentiment.

The outlook for residential construction remained more promising. Spurred by reduced mortgage rates, sales of homes continued on a moderate uptrend in most areas and, indeed, represented a bright spot in some otherwise depressed regions such as New England. While the construction of new housing was still being damped by relatively high vacancy rates and the difficulties encountered by some builders in obtaining financing, modest strengthening in homebuilding was occurring in many parts of the country. The recent decline in long-term interest rates was cited as a further favorable factor for housing construction activity.

Turning to the outlook for the nation's trade balance, members commented that export demand had continued to grow and several expressed optimism regarding the prospects for further growth, including the outlook for expanding markets in Latin America. The trade balance would be influenced to an important extent by the value of the dollar in foreign exchange markets; the latter was subject to considerable uncertainty, especially in connection with the events that were under way in the Soviet Union. Those events had raised questions about trade developments, notably the potential for reduced world oil supplies and lower foreign demand for U.S. goods, especially agricultural products. The members also recognized that the domestic

economic expansion would have a damping effect on the trade balance by stimulating growth in imports.

The members anticipated that federal government purchases of goods and services would be curtailed in line with last year's budget agreement. They noted that the recent developments in the Soviet Union had raised new uncertainties about the size of cutbacks in defense spending which had been projected to account for all the reduction in real federal expenditures. With regard to the state and local governments, there continued to be widespread reports of current or expected spending cuts and higher taxes to counter budgetary shortfalls. On balance, overall government spending and tax policies appeared likely to exert a somewhat negative influence on the economic expansion.

Given a projection of some persisting slack in labor and product markets and following an extended period of relatively restrained monetary growth, the members continued to anticipate appreciable progress toward lower inflation over the period through 1992. Competitive pressures, including competition from foreign producers, remained strong in markets for many products, and the decline in consumer inflation over the course of recent months was likely to have a favorable effect on inflationary expectations. On the negative side, the recent lack of progress in bringing down the rate of increase in labor costs was a worrisome development. While some of the upward pressures on such costs appeared to reflect special factors such as the second-quarter rise in the minimum wage, a major underlying cause was the continuing surge in the cost of benefits, especially medical insurance. In this situation, several members observed that they now anticipated less progress toward a lower core rate of inflation over the next several quarters.

Against the background of a broad consensus that a moderately paced recovery with ebbing inflation probably was under way, all of the members indicated that they preferred or could accept a proposal to maintain an unchanged degree of pressure on reserve positions. In addition, a majority expressed a preference for an asymmetric directive that was tilted toward possible easing during the weeks ahead. Those favoring such asymmetry felt that the risks to the expansion were largely on the side of a weaker than projected economy, and they believed that the Federal Reserve should react promptly to any signs that the expansion was less robust than desired or that monetary conditions might be inconsistent with sustained growth. However, they believed that an immediate easing move would be premature because the most recent economic information, although mixed, still suggested a moderate rate of economic expansion and also because of the questions that were raised about how to interpret the behavior of the monetary aggregates. Some members marginally favored an immediate move toward ease because of the weakness in the broader monetary aggregates and a sense that such a move might bolster confidence and better assure a satisfactory recovery in the months ahead. Nonetheless, they found acceptable an initially unchanged policy that was coupled with an instruction calling for policy implementation to be especially alert to developments that might require some easing during the intermeeting period. Other members viewed the risks to the expansion as more evenly balanced or questioned the extent to which further easing in the near term might stimulate monetary growth or result in lower long-term interest rates. Accordingly, they felt that retaining the current symmetric directive was a preferable option. They were concerned about the risk of responding to what might prove to be short-lived fluctuations in the economic data and anecdotal

information bearing on the performance of the economy. In particular, the persistence of inflationary cost pressures made it advisable to pause in order to assess the implications of the information that would become available over the next few weeks, including data on the behavior of the monetary aggregates. Nonetheless, given prevailing uncertainties, these members could accept a directive that was biased toward possible easing in the weeks ahead.

In the course of the Committee's discussion, members devoted considerable attention to the behavior of the monetary aggregates. While the cumulative growth of M2 and M3 for the year to date was still within the Committee's ranges--though near the bottom of those ranges--the weakness in recent months, including declines in both aggregates in July, was seen by many members as a disturbing development. The members acknowledged that it was difficult to disentangle the various reasons for the unexpected shortfall in monetary growth and thus the implications for the thrust of monetary policy. In the context of essentially unchanged or even declining interest rates, there appeared to be little import for the economy and monetary policy to the extent that the shortfall reflected shifts of funds out of the broader aggregates and into nonmonetary investment instruments that provided higher interest returns, thereby bypassing depository institutions but tending to have little effect on the overall availability of credit. Of potentially greater concern and significance for policy was the evidence that some of the weakness of the monetary aggregates stemmed from unusual constraints on the amount of credit provided by depository institutions and implied restraint on the overall supply of credit. The weak growth in credit extended by depository institutions reflected, of course, an uncertain combination of anemic demand by

credit-worthy borrowers and supply constraints by lending institutions. The behavior of M2 and M3 also might be indicative of even weaker nominal spending than was currently recognized and hence a monetary policy stance that was too tight under such circumstances. According to a staff analysis prepared for this meeting, growth in both measures could be expected to pick up a little over the months ahead, assuming steady reserve conditions. The persistence in some degree of recent relationships between movements in short-term interest rates, income, and monetary growth would imply slower monetary expansion than might otherwise be expected.

In these circumstances, many members indicated that continued weakness in M2 and M3 would be a matter of increasing concern, especially given questions about the strength of the economic recovery. Some favored a proposal to give greater emphasis in the directive to the behavior of the monetary aggregates in guiding possible intermeeting adjustments in policy, at least for the period ahead. However, a majority preferred to retain the current directive wording. In support of this view, some commented that in recent years the broader aggregates have been unreliable indicators of the path of the economy over the quarters immediately ahead and thus imperfect guides for short-run policy adjustments. Some observed that growth in M1 and total reserves had held up fairly well on balance over the past several months and that the behavior of those measures might be more indicative of the underlying thrust of monetary policy than that of the broader aggregates on which the Committee had tended to focus. Giving the monetary aggregates more prominence in the directive could provide a misleading indication of the adjustments that would be made to reserve conditions in response to the behavior of the aggregates.

including aberrant fluctuations, thereby misconstruing the views of many members.

At the conclusion of the Committee's discussion, all of the members indicated that they could vote for a directive that called for maintaining the existing degree of pressure on reserve positions. All also indicated that they preferred or could accept a directive that included a bias toward possible easing during the intermeeting period. Accordingly, the Committee decided that somewhat greater reserve restraint might be acceptable or somewhat lesser reserve restraint would be acceptable during the period ahead depending on progress toward price stability, trends in economic activity, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets. The reserve conditions contemplated at this meeting were expected to be consistent with a resumption in the growth of M2 and M3 during the weeks ahead, but in light of the declines in these aggregates since June, the Committee now anticipated that M2 would be little changed and M3 would be down at an annual rate of about 1 percent in the period from June through September.

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 has been mixed, but it suggests on balance that economic activity is expanding at a moderate pace. The unemployment rate fell slightly to 6.8 percent in July, but total nonfarm payroll employment edged down and the average workweek posted a sharp decline. Industrial production rose appreciably further in July. Consumer spending has increased considerably in recent months, led by sizable gains in expenditures for motor vehicles. New orders for nondefense capital goods point to little change in spending for business equipment over the near term, and nonresidential construction remains weak. Housing starts rose further in June and July. The nominal U.S. merchandise trade deficit declined in June, and its average for the second quarter was somewhat below the rate in the first quarter. Increases in consumer prices have been small in recent months.

Over the intermeeting period prior to August 19, market interest rates declined appreciably and the trade-weighted value of the dollar in terms of the other G-10 currencies depreciated somewhat. Subsequently, in the wake of events in the Soviet Union, Treasury bill rates fell somewhat further and the dollar rebounded sharply against many European currencies.

M2 contracted in July after several months of slow growth and M3 fell further. For the year through July, expansion of M2 and M3 has been near the lower ends of the Committee's ranges.

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 2-1/2 to 6-1/2 percent and 1 to 5 percent, respectively, measured from the fourth quarter of 1990 to the fourth quarter of 1991. The monitoring range for growth of total domestic nonfinancial debt also was maintained at 4-1/2 to 8-1/2 percent for the year. For 1992, on a tentative basis, the Committee agreed in July to use the same ranges as in 1991 for growth in each of the monetary aggregates and debt, measured from the fourth quarter of 1991 to the fourth quarter of 1992. With regard to M3, the Committee anticipated that the ongoing restructuring of thrift depository institutions would continue to depress the growth of this aggregate relative to spending and total credit. 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 to maintain the existing degree of pressure on reserve positions. Depending upon progress toward price stability, trends in economic activity, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, somewhat greater reserve restraint might or somewhat lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with a resumption of growth of M2 and M3 in the weeks ahead; but in view of the declines already

posted since June, the Committee anticipates that M2 would be little changed and M3 would be down at an annual rate of about 1 percent over the period from June through September.

Votes for this action: Messrs. Greenspan, Corrigan, Angell, Black, Forrestal, Keehn, Kelley, LaWare, Mullins, and Parry.

Votes against this action: None.