FEDERAL RESERVE press release

For Use at 4:30 p.m. November 8, 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 October 1, 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

1. Domestic policy directive

The information reviewed at this meeting suggested that economic activity expanded in the third quarter at an annual rate of about 3 percent, compared with a rate of about 1 percent in the first half of the year. While the increase in total spending by domestic sectors was a little weaker than in the first half, growth in domestic output was higher because the trade balance in the third quarter apparently did not deteriorate further. Broad measures of prices and wages appeared to be rising at rates close to or somewhat below those recorded earlier in the year.

The index of industrial production increased 0.3 percent in August. Production gains were particularly strong for consumer durable goods -- mainly because of a spurt in assemblies of light trucks -- and for defense and space equipment. Estimates for the preceding three months were revised down, however, and the level of output in August was about 1/2 percent above the average for the second quarter. Industrial capacity utilization edged up to 80-1/2 percent, little changed since spring and about 1-1/2 percentage points below its level a year earlier.

The nominal value of retail sales increased nearly 2 percent in August, mainly reflecting a surge in auto sales after the introduction of financing incentive programs in mid-August. Sales of new domestic automobiles rose to an annual rate of 9-1/2 million units for the month and accelerated further to a rate of 12 million units during the first 20 days of September. Outlays for consumer goods other than autos also posted gains in August, but have shown little change on balance since early spring.

Total nonfarm payroll employment expanded by about 300,000 in August, well above the average gain in the preceding four months. Hiring continued to be brisk in service-producing industries and at finance and trade establishments. Moreover, employment in manufacturing rose for the first time since January, but the gains might have been overstated because of seasonal adjustment difficulties associated with a shift in timing of the model changeover period in the automotive industry. The civilian unemployment rate, which had held steady at 7.3 percent since February, fell to 7.0 percent in August.

Private housing starts picked up in August but, at an annual rate of 1-3/4 million units, were the same as the average recorded in the second quarter. Other indicators suggested an improved tone in the housing sector. Sales of new homes continued to trend up through July, and sales of existing homes registered a sizable advance in August. Moreover, newly issued permits for residential building remained at relatively high levels, and consumer attitudes toward buying homes apparently continued to be quite positive.

Incoming information suggested a leveling of business capital expenditures. Spending for nonresidential structures has slowed in recent months. Shipments of nondefense capital goods rebounded in August, about offsetting the previous month's decline. New orders also rose somewhat after a sharp drop in July, but that reflected a substantial rise in the volatile aircraft category; excluding such orders August showed an appreciable decline.

The U.S. merchandise trade deficit in July and August averaged somewhat less than that recorded in the second quarter of the year, as a drop in imports was partly offset by a slight decline in exports. The drop in imports was widespread across all major commodity categories, with especially large declines in oil, industrial supplies, capital goods, and consumer goods.

Recent data on prices and wages suggested that inflation has been holding steady at rates somewhat lower than those earlier in the year. The producer price index for finished goods fell 0.3 percent in August, as prices for consumer foods and energy-related items declined and overall prices of other consumer goods were unchanged. The consumer price index rose 0.2 percent in August for the fourth consecutive month, less than the average monthly change in the January-to-April period. During the first eight months of this year, producer and consumer prices and the index of average hourly earnings have risen at rates somewhat below those recorded in 1984.

Following the Committee's meeting in August, the trade-weighted value of the dollar against major foreign currencies appreciated more than 5 percent through mid-September. The dollar subsequently declined sharply, especially after the announcement on September 22 by the finance ministers and central bank governors of the G-5 countries that recent shifts in fundamental economic conditions had not been reflected fully in exchange markets. It was noted in the announcement by the G-5 countries that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-dollar currencies against the dollar was desirable. By the time of this meeting the value of the dollar had declined about 3-1/4 percent on balance since the August meeting to a level nearly 20 percent below its peak in late February.

At its meeting on August 20, 1985, the Committee had adopted a directive that called for maintaining the slightly firmer degree of reserve restraint that had been sought in previous weeks. That action was expected 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. Growth of M1 was expected to slow from its recent pace, but given the rapid expansion since June, M1 was anticipated to grow at an annual rate of about 8 to 9 percent over the three-month period, considerably above earlier expectations. The members 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 in the event of substantially slower monetary growth. In either case, adjustments in the degree of reserve pressures 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 intermeeting range for the federal funds rate was retained at 6 to 10 percent.

M1 growth surged in August to an annual rate just over 20 percent, reflecting exceptional strength in interest-bearing checkable deposits and relatively rapid expansion in other components. Data for the first half of September suggested slower but still substantial expansion in M1. Thus, for the period from June to September M1 was expanding at a rate well above the Committee's expectations, and was at a level substantially higher than the path consistent with the Committee's range for the second half of the year. Reflecting the surge in M1, M2 accelerated in August to an annual rate of about 11-1/4 percent and M3 also strengthened to a rate of about 8-1/2 percent; growth in these broader aggregates was running slightly above the rates anticipated for the June-to-September period. Relative to their long-run ranges for the year, M2 was close to the top of its range while M3 was near the middle of its range. Growth in total domestic nonfinancial debt remained relatively rapid in August, and thus far in 1985 was running somewhat above the upper end of its growth range for the year.

In the light of growth in the monetary aggregates -- especially M1 -- continuing to exceed expectations, and with indications of a somewhat stronger tone in the economy as the intermeeting period progressed, open market operations during the period were directed toward maintaining or slightly increasing the degree of reserve restraint that had been sought shortly before the meeting on August 20. As a result, the level of adjustment plus seasonal borrowing rose somewhat on balance in the intermeeting interval, averaging about $515 million in the latest reserve maintenance period ending September 25. Borrowing had been running substantially higher in recent days, however, because of technical market conditions associated with a hurricane on the East Coast and the end-of-quarter statement date.

The small increase in reserve pressures, measured by the average level of borrowings, was not reflected in a significant change in money market interest rates, and the federal funds rate generally moved in a narrow range of 7-3/4 to 8 percent throughout the intermeeting period, averaging close to 8 percent in the week prior to this meeting. For Treasury securities, most short-term yields were unchanged to down slightly, influenced by a large paydown of Treasury bills because of debt ceiling problems, while long-term yields were up about 5 to 10 basis points. Most other market interest rates also showed small, mixed changes over the period. But yields on some federal agency securities advanced relatively sharply in the wake of reports about financial difficulties of the Farm Credit System.

The staff projections presented at this meeting were little changed from those prepared at the time of the August meeting. Growth in real GNP was projected to pick up somewhat in the second half of the year from the sluggish pace in the first half and to continue at a modest pace throughout 1986. The average unemployment rate was expected to change little over the period, and the rate of increase in prices was projected to remain close to that experienced in the past few years.

In the Committee's discussion of the economic situation, the members generally took the view that the latest information was consistent with some improvement in the rate of economic growth. They differed to some extent in their assessments of the prospects for the economy, however. Several thought that moderate growth in line with the staff projection, or perhaps a bit faster, was a reasonable expectation for the quarters ahead. Growth could pick up as domestic demands were maintained, given the large buildup in liquidity over recent months, the big federal deficit, and the possibility that the international trade position of the United States would stop worsening. On the other hand, a few members stressed the downside risks in various sectors of the economy, such as potential restraint on consumer spending because of the large buildup in debt, the weak performance in manufacturing attributable in part to competitive pressures from abroad, and the continued signs of deterioration in the agricultural sector. They expressed the view that continued sluggish expansion was the more likely course for the economy. As had been the case at previous meetings, the members emphasized that a variety of problems and financial strains in some sectors of the economy, stemming to a substantial extent from the massive imbalances in the federal budget and in foreign trade, represented ongoing threats to the sustainability of the expansion.

Considerable attention was focused on the performance of the dollar in foreign exchange markets and the implications of possible changes in exchange rates for the balance of trade and the domestic economy. The members also reviewed developments relating to the foreign debt problems of less developed countries. In the course of discussion members recognized, as in previous meetings, that the extraordinary strength of the dollar earlier had contributed to the size of the trade deficit, but they also emphasized the importance of maintaining underlying confidence in the dollar, given the dependence of the United States for the time being on large capital inflows. It was noted that the possibility, while perhaps remote, of a precipitate continuing decline in the value of the dollar would present a threat to the financial system and the economy because of its potential implications for higher interest rates and inflationary pressures, particularly in the absence of stronger budgetary restraint than had yet been achieved. Protectionist legislation would aggravate the potential difficulties. Consequently, it would be important that shifts in the value of the dollar be orderly.

Several members referred to the generally favorable trends in wages and prices over the course of recent months. Some concern was expressed, however, that inflationary expectations for the longer term might be increasing in the context of the large increase in M1 and total debt, disappointment over the limited progress made thus far in reducing federal budget deficits, and against the background of recent and possible further declines in the foreign exchange value of the dollar. Some members also suggested that a view may be becoming more widespread -- encouraged perhaps by the continued rapid expansion in M1 -- that an effective monetary policy directed at maintaining and reinforcing progress toward price stability might be inhibited by sensitive conditions in some business and financial sectors of the domestic economy and in international financial markets, particularly as long as the federal budget deficit remained so large.

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 had 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. At this meeting, there was some further discussion of the 1985 range for M1 and its role, but no change was made at this time.

In the Committee's discussion of policy implementation for the weeks immediately ahead, the continuing strength of M1 was assessed against the background of relatively modest expansion in economic activity and the absence of indications that inflation was increasing. According to an analysis prepared for this meeting, M1 growth could be expected to moderate substantially over the months ahead, even as the economy continued to expand, following its exceptionally rapid rate of growth since late spring and the resulting large buildup in liquidity. The most recent data on M1 lent some weight to the outlook for considerable slowing in this aggregate. Moreover, given the volatility of the M1 data and the difficulties of making seasonal adjustments, a decline in M1 for a time could not be ruled out. In general, however, growth in M1 could be expected to be sustained over the fourth quarter as a whole in part by the prospect that inflows of savings funds into NOW accounts were likely to continue, at least at a moderate rate, unless market interest rates rose quite substantially from current levels. In the circumstances, it appeared increasingly doubtful that the targeted rate of M1 growth for the second half of the year as a whole could be reached without an inappropriately abrupt increase in reserve pressures and in interest rates. Growth in M2 and M3 was expected to remain roughly consistent with the target ranges for 1985, and much slower growth in M1 -- consistent with the upper end of its target -- would in the view of many members be acceptable and desirable, depending upon developments in the economy and financial markets.

As they had at the previous meeting, the members agreed that in prevailing circumstances, including a relatively strong dollar, the surge in M1 did not appear in itself to have inflationary implications for the time being. Nonetheless, while relatively rapid growth in M1 might be tolerated for a time, concern was expressed that the longer such growth persisted, the greater would be its potential for translation into inflationary demand pressures. A number of members also emphasized that the recent strength in M1 could not be explained fully by such factors as institutional changes and financial innovations or by shifts of funds to NOW accounts in response to earlier declines in market interest rates.

The members placed considerable emphasis on the need to judge the behavior of M1 in the context of the performance of the economy and the relatively moderate growth in the broader aggregates. Currently sensitive conditions in domestic and international financial markets and debt problems in some sectors of the economy such as agriculture were themselves a restraining force on the economy and argued against a policy course that might entail appreciably higher interest rates in the short run. On the other hand, significant easing under immediately prevailing market circumstances would incur too much risk of prolonging undue growth in money and debt, possibly triggering an abrupt and exaggerated decline in the foreign exchange value of the dollar with disturbing implications for inflation and financial markets over time.

While individual members expressed some shadings of opinion regarding policy implementation over the weeks ahead, it was generally agreed that the balance of considerations bearing on the Committee's decision argued for little or no change from the recently prevailing degree of pressure on reserve positions. At the conclusion of the Committee's discussion, a directive that called for maintaining the degree of reserve pressure sought in recent weeks was favored by most members. They expected such an approach to policy implementation to be consistent with growth of both M2 and M3 at annual rates of around 6 to 7 percent for the period from September to December. Over the same period, growth in M1 was expected to slow markedly -- also to an annual rate of 6 to 7 percent -- and even slower growth would be acceptable in the context of satisfactory economic performance, given the very rapid expansion experienced in recent months. The members agreed that somewhat greater or lesser reserve restraint would be acceptable over the intermeeting period, depending on the behavior of the monetary aggregates and taking account of appraisals of the strength of the business expansion, the performance of the dollar in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. It was also understood that policy might be implemented with somewhat more flexibility than usual over the relatively short intermeeting period, given the uncertainties associated with particularly sensitive conditions in the foreign exchange and other 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 expanded in the third quarter at a moderately faster rate than in the first half of the year. In August, industrial production increased somewhat. Total retail sales rose considerably, boosted by a surge in auto sales. Housing starts, while increasing in August, were still no higher than their average level in the second quarter. Incoming information generally suggested a leveling of business capital spending. The merchandise trade deficit in July and August averaged somewhat less than in the second quarter as a drop in imports was partly offset by a slight decline in exports. Total nonfarm payroll employment rose somewhat more in August than in most other recent months. The civilian unemployment rate fell from 7.3 percent in July -- its level since February -- to 7.0 percent in August. Broad measures of prices and wages appear to be rising at rates close to or somewhat below those recorded earlier in the year.

Following the Committee's meeting on August 20, the trade-weighted value of the dollar against major foreign currencies appreciated through mid-September. The dollar subsequently declined sharply, especially after the announcement on September 22 by the Finance Ministers and Central Bank Governors of the G-5 countries that exchange rates have not fully reflected economic fundamentals.

M1 growth surged in August, reflecting exceptional strength in interest-bearing checkable deposits and relatively rapid expansion in other components; data for the first half of September suggest slower but still substantial expansion. Reflecting the surge in M1, M2 accelerated in August, and M3 also strengthened somewhat. Expansion in total domestic nonfinancial debt has remained relatively rapid. Most market interest rates have changed little on balance since the August 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 over the period from September to December at annual rates of about 6 to 7 percent. A marked slowing of M1 growth over the period to an annual rate of around 6 to 7 percent is also anticipated; slower growth over the next three months would be acceptable in the context of satisfactory economic performance, given recent very rapid growth in M1. Somewhat greater or lesser reserve restraint would be acceptable depending on behavior of the aggregates, taking account 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 reserve conditions during the period before the next meeting are 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, Ms. Seger, and Mr. Wallich. Vote against this action: Mr. Black.

Mr. Black dissented because he believed some increase in the degree of reserve pressure was needed at this time to insure adequate slowing of M1 growth in the period ahead.

2. Authorization for Foreign Currency Operations

At this meeting the Committee also considered the need for adjustment in the limit on holdings of foreign currencies in the System Open Market Account. At present, Paragraph 1D of the Committee's authorization for foreign currency operations authorized the Federal Reserve Bank of New York, for the System Open Market Account, to maintain an overall open position in all foreign currencies not exceeding $8.0 billion. System holdings of foreign currencies currently totaled about $5-1/2 billion, based on historical costs. In light of the potential for foreign exchange operations by the United States and other countries following the recent G-5 announcement, the Committee agreed to raise the limit in paragraph 1D of the authorization to $10.0 billion, effective immediately.

Votes for this action: Messrs. Volcker, Corrigan, Balles, Black, Forrestal, Keehn, Martin, Partee, Rice, Ms. Seger, and Mr. Wallich. Votes against this action: None.