FEDERAL RESERVE press release

For Use at 4:30 p.m. September 26, 1986

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 19, 1986.

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 19, 1986

Domestic policy directive

The information reviewed at this meeting indicated an uneven pattern of developments in different sectors of the economy but suggested on balance that economic activity was expanding at a moderate pace in the current quarter. Consumer spending and housing activity have been relatively robust, while business investment has remained sluggish and the trade balance does not appear to have improved. On average, prices and wages have risen more slowly this year than in 1985, although fluctuations in energy costs have resulted in some month-to-month volatility.

Total nonfarm payroll employment grew strongly in July, rising nearly 1/4 million after adjustment for strikes, well above the average monthly gains during the first half of the year. Hiring was up in construction and remained robust in the trade and service sectors. However, manufacturing employment registered another drop, bringing the cumulative decline since January to 175,000. The civilian unemployment rate declined 0.2 percentage point to 6.9 percent, toward the lower end of the range that has prevailed over the past year.

The index of industrial production edged down 0.1 percent in July after declining 0.3 percent in June. Since reaching its most recent peak in January, the index has dropped about 2 percent. Despite increased production in July in industries affected by the settlement of strikes, particularly the communication equipment industry, output has remained generally sluggish.

Weakness has persisted in the output of business equipment and consumer goods, although the direct effects of declines in petroleum drilling are beginning to wane; automobile assemblies were down 400,000 in July, but the decline was largely offset by gains in the production of light trucks. Capacity utilization in manufacturing, mining, and utilities decreased 0.2 percentage point further in July to 78.2 percent; during the past six months the overall rate of capacity utilization has fallen 2.6 percentage points.

Total retail sales were about unchanged in June and July; however, excluding automobiles, gasoline, and nonconsumption items, retail sales increased 0.7 percent in July after an upward-revised increase of 0.4 percent in June. Sales remained particularly strong at furniture and appliance stores. Total car sales slipped to a 10.9 million unit annual rate in July, as a drop in sales of domestic models more than offset an increase in foreign car sales.

Residential construction activity has continued to expand, reflecting the rise in housing starts earlier in the year. However, the level of starts has tapered off recently from the exceptional pace of the early spring, reflecting in part high vacancy rates and tax law changes that have damped multifamily construction. In June, total private starts were at an annual rate of 1-3/4 million units. Sales of single-family homes also weakened in May and June, but from a very high April peak.

Business fixed investment apparently remained sluggish with the weakness concentrated in nonresidential structures. The sharp curtailment of petroleum drilling contributed to a further decline in the nonresidential structures component, although commercial and industrial construction also fell. Moreover, new commitments for nonresidential construction have fallen sharply since late last year, suggesting that outlays may retreat further during the third quarter. In contrast to structures, outlays for equipment rose markedly in the second quarter, led by a rebound in office and computer equipment; however, this gain only partly reversed a sharp decline in the first quarter. New orders for nondefense capital goods fell for three consecutive months before posting a small gain in June. Inventory data for the second quarter, though incomplete, suggested a marked slowdown in the rate of accumulation, as auto dealers pared stocks slightly after two quarters of rapid accumulation.

Wage increases appear to have slowed further this year, and, except for a June rebound in consumer energy prices, recent price data have reflected continued restraint through midyear. The producer price index fell 0.4 percent in July, and the consumer price index excluding energy was up 0.2 percent in June. For the second quarter as a whole, the CPI excluding energy rose at an annual rate of about 3 percent, down almost a full percentage point from the first quarter. In the commodity markets, the price of crude oil on spot markets fell through much of July, but then rose sharply following an accord by OPEC to restrain production. At the same time, livestock and poultry prices have moved higher while gold and platinum prices have soared, apparently largely reflecting expectations of reduced supplies.

Since the July FOMC meeting, the weighted-average foreign exchange value of the dollar declined a further 3-1/2 percent on balance; the dollar depreciated almost 5-1/2 percent against the mark and somwhat less against the yen. The reduction in the discount rate by the Federal Reserve announced on July 10 and the failure of other central banks to follow apparently contributed to the dollar's weakness. Short-term interest rates abroad were little changed during the intermeeting period while comparable U.S. rates declined about one-third of a percentage point. The differentials between long-term interest rates in the United States and comparable rates in Germany and Japan were about unchanged on balance. The U.S. merchandise trade deficit in the second quarter appeared unchanged from the first quarter. The value of oil imports continued to fall, while that of non-oil imports rose further. About one-half of the increase in the value of non-oil imports apparently reflected rising import prices.

At its meeting on July 8-9, the Committee adopted a directive that called for decreasing somewhat the existing degree of pressure on reserve positions, taking account of the possibility of a change in the discount rate. The members expected such an approach to policy to be consistent with growth in M2 and M3 over the period from June to September at annual rates of 7 to 9 percent. Over the same period growth in M1 was expected to moderate from the rapid pace in the second quarter. The Committee agreed that it would continue to evaluate M1 in light of the broader aggregates and other factors. The members also acknowledged that somewhat greater or lesser reserve restraint might be acceptable depending on the behavior of the aggregates, 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 reduced 1 percentage point to 4 to 8 percent.

An easing in reserve conditions was implemented shortly after the July meeting through a half point reduction in the discount rate to 6 percent.

In the two complete reserve maintenance periods since the meeting, adjustment plus seasonal borrowing at the discount window averaged just under $400 million, somewhat higher than in the previous intermeeting period. A portion of this borrowing, however, reflected adjustment credit to depository institutions facing special situations. Incoming data during the intermeeting period indicated that growth of all of the monetary aggregates accelerated in July. M2 and M3 were estimated to have expanded at annual rates of 12-3/4 and 13 percent, respectively. The rapid growth in the broader aggregates pushed them into the upper portions of their ranges for 1986. At the same time growth in M1 in July was close to the extraordinary pace of the second quarter.

Federal funds generally traded in the 6-1/4 to 6-3/8 percent area after the 1/2 percentage point cut in the discount rate announced on July 10, down from the 6-7/8 percent rate prevailing at the time of the July meeting. With the reduction in the discount rate widely anticipated, however, other interest rates generally did not post comparable declines. While rates on short-term securities have fallen 25 to 50 basis points over the intermeeting period, yields in the longer-term markets have been about unchanged to only slightly lower on balance. The recent behavior of longer-term interest rates has reflected in part uncertainty about the prospects for further rate declines in light of the absence of policy actions abroad to reduce interest rates as well as a cautious interpretation of incoming economic and price news, including the possibility of some increase in inflationary pressures over time.

The staff projections presented at this meeting suggested that growth in real GNP likely would pick up somewhat in coming months. Growth was forecast to continue at a moderate pace in 1987. A projected improvement in the U.S. trade position was anticipated to be a key element supporting growth in domestic production over the next year and a half. Over the same time period, growth in domestic demand was expected to be relatively sluggish. The rate of inflation was anticipated to edge up in coming quarters, partly reflecting upward pressure on prices from the effects of the dollar's depreciation as well as the diminishing impact of oil price declines, which had served to hold down price indexes thus far in 1986. The civilian unemployment rate was forecast to drop somewhat over the projection horizon .

In the Committee's discussion of the economic situation and outlook, members focused considerable attention on the uncertain prospects for the nation's foreign trade deficit. They saw trade developments as a key element in the outlook for domestic business activity, and several commented that the business expansion might well remain relatively weak if the trade balance did not show significant improvement over the quarters ahead. The substantial depreciation of the dollar against major foreign currencies was still expected to foster a turnaround in net exports at some point, but the absence of progress to date could be read as auguring a muted as well as a further delayed response to the dollar's depreciation.

During the discussion, a number of members emphasized that improvement in the trade balance was being inhibited by relatively sluggish economic activity in several key industrial nations abroad. Other developments working in the same direction included the lack of dollar depreciation against the currencies of a number of developing countries that had important trading relationships with the United States, the severe debt problems of several less developed nations, and the competition in agricultural export markets stemming from large grain harvests in many parts of the world. On the more positive side, members referred to the apparently more favorable prospects for economic expansion in a major European country. Some members also commented that while improvement in the trade balance had been more delayed than many had expected, some historical experience in combination with current circumstances provided reasons for remaining optimistic that a substantial turnaround in trade would occur later, perhaps toward the end of this year or in early 1987.

The members differed to some extent in their assessment of domestic developments bearing on the economic outlook. While economic performance remained uneven in different sectors of the economy and parts of the country, overall consumer spending and the demand for housing were being well maintained in association with continuing gains in employment and incomes and reduced interest rates. One member observed that, given generally lean inventories outside the automobile industry, further gains in consumer spending were likely to stimulate increasing domestic production at some point. A number of members also referred to the relatively rapid growth in money balances as a factor that would tend to support business activity over the quarters ahead. On the negative side, rising consumer debt burdens were likely to restrain the expansion in consumer spending and business investment showed no evidence of an appreciable pickup.

The members recognized that a number of developments, in addition to the uncertainties surrounding the outlook for trade, were currently clouding economic prospects. These included the tax reform legislation whose overall impact was very difficult to predict, especially for the next several quarters, because of the very comprehensive and complex changes incorporated in the legislation. In the consumption area, for example, the loss of deductibility for sales taxes starting in 1987 and the phase-out of interest deductions on consumer debt might tend to restrain spending on consumer durables over time, but some members noted that it might also stimulate such spending over the balance of the year. The impact of the new legislation on business investment was especially hard to assess. It was suggested that on balance the impact might tend to be negative for some time, but many businessmen apparently saw the removal of uncertainties about the legislation as a positive development for the nearer term. Members also commented that the outlook for the federal budget deficit and its consequent impact on the economy remained unclear.

With regard to the prospects for inflation, the members generally were not concerned about a resurgence in the nearer term, but several expressed uneasiness about the longer-run outlook. Members referred to the inflationary implications of relatively rapid monetary growth, especially if it continued, and to the further impact of the dollar's depreciation on prices of imports and competing domestic products. In the latter connection one member observed that, despite relatively large inventories, domestic producers of automobiles were raising their prices in response to increases in the prices of competing imports. One member also expressed concern that the new tax reform legislation, to the extent that it shifted tax burdens to businesses, could put upward pressures on prices, at least initially. The favorable direct effects of large declines in oil prices now appeared to be in the past, and one member observed that commodity prices more generally might be poised for an upturn. Some members saw indications that inflationary expectations were starting to intensify, even though actual prices and wages generally were rising less rapidly this year than in 1985.

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 1986 and had set tentative objectives for expansion in 1987. For the period from the fourth quarter of 1985 to the fourth quarter of 1986, the Committee had reaffirmed the ranges established in February for growth of 6 to 9 percent for both M2 and M3. The associated range for expansion in total domestic nonfinancial debt also was reaffirmed at 8 to 11 percent for 1986. With respect to M1, the Committee decided that growth in excess of the 3 to 8 percent range set in February would be acceptable and would be evaluated in the light of the behavior of M1 velocity, the expansion of the broader aggregates, developments in the economy and financial markets, and price pressures. For 1987 the Committee agreed on tentative monetary growth objectives that included a reduction of 1/2 percentage point to a range of 5-1/2 to 8-1/2 percent for both M2 and M3. In the case of M1 the Committee expressed the preliminary view that retention of the 1986 range of 3 to 8 percent, which implied a considerable reduction from the actual rate of growth that now seemed likely for 1986, appeared appropriate for 1987 in the light of most historical experience. The Committee also retained the range of 8 to 11 percent for growth in total domestic nonfinancial debt in 1987. It was understood that all the ranges were provisional and that, notably in the case of M1, they would be reviewed in early 1987 in the light of intervening developments.

In the Committee's discussion of policy implementation for the weeks immediately ahead, a number of members suggested that any further easing might be accomplished through a further one-half percentage point reduction in the discount rate, while open market operations would be directed toward maintaining an essentially unchanged degree of reserve availability. Some members expressed reservations about such a reduction, especially in the absence of indications that it would be followed fairly promptly by policy easing actions in major industrial nations abroad. In this view a unilateral decrease in the discount rate might foster substantial additional depreciation in the dollar, with adverse repercussions on investor willingness to hold dollars. Several members, however, saw a lesser risk to the dollar or one that needed to be accepted. Some wanted to reduce the risks of rapid dollar depreciation by a small increase in the degree of reserve pressure in the event of a reduction in the discount rate. Several other members indicated that they did not agree. While some firming should not be ruled out in their view, it should be made contingent on an adverse move in the exchange rate and other potential developments such as evidence of greater inflationary danger and stronger business activity. One member also commented that any increase in the degree of reserve pressure had to be weighed against the risk of triggering a rise in long-term interest rates; such a rise, if it occurred, would weaken the prospects for a pickup in the rate of economic expansion.

In further discussion, Committee members expressed some concern about the continuation of rapid growth in the monetary aggregates and the implications of such growth for potential inflation later. The members recognized that much of the rapid growth, especially in M1, probably reflected increasing demands for liquid assets in response to declining interest rates and subsiding inflation rather than excessive money creation with potentially inflationary consequences. They also felt that M1 growth should continue to be evaluated in the context of a relatively sluggish economy and in light of the expansion in the broader aggregates. While a sluggish economic performance would dampen inflationary risks, continuing growth in M2 and M3 at the relatively rapid rates experienced recently might be a matter of growing concern, especially if such expansion tended to coincide with indications of stronger business activity.

In their evaluation of the outlook for monetary growth, the members took into account an analysis which indicated that much slower expansion, especially in the broader aggregates, was likely to develop over the next few months if short-term interest rates stayed around their current levels. On the other hand, monetary growth might remain relatively rapid over the period ahead if short-term rates were to drop somewhat further. The members recognized that the timing and extent of any slowing in monetary growth remained subject to a great deal of uncertainty.

In the discussion of possible intermeeting adjustments in the degree of reserve pressure, the members agreed that a degree of flexibility would be useful, taking into consideration whether or not the discount rate was reduced and subsequent developments in domestic financial markets and especially in foreign exchange markets. If the discount rate were not reduced, a slight easing in pressure on reserve positions might be appropriate. Alternatively, if the discount rate were reduced and the reduction was followed by a substantial weakening of the dollar in foreign exchange markets, a little greater caution in the provision of reserves through open market operations would be appropriate. In keeping with the Committee's usual practice, consideration also would need to be given to ongoing economic and financial developments and the growth of the monetary aggregates. Such developments might warrant an adjustment in either direction.

At the conclusion of the Committee's discussion, all but two members indicated that they favored or could accept a directive that called for some slight easing in the degree of reserve pressure, taking account of the possibility that such easing might be accomplished through a reduction in the discount rate. The members expected this approach to policy implementation to be consistent with growth in M2 and M3 at annual rates of about 7 to 9 percent over the June-to-September period. Over the same interval, growth in M1 was expected to moderate from the exceptionally large increase during the second quarter. With the prospective behavior of M1 remaining subject to unusual uncertainty, the Committee again decided not to specify a rate of expected growth in the operational paragraph of the directive but to continue to evaluate this aggregate in the light of the performance of the broader aggregates and other factors. The Committee indicated that it might find somewhat greater or somewhat lesser reserve restraint acceptable over the intermeeting period depending on the decision with respect to the discount rate and on such other factors as the behavior of the monetary aggregates, 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. 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 4 to 8 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 indicates a mixed pattern of developments but suggests on balance that economic activity is expanding moderately in the current quarter. In July total nonfarm payroll employment grew strongly, boosted in part by the return of striking workers. However, continued weakness in the industrial sector was reflected in further declines in employment in manufacturing and mining. The civilian unemployment rate moved down to 6.9 percent from 7.1 percent in June. Industrial production declined slightly further in July. The nominal value of total retail sales was about unchanged during the month, as sales of new autos declined somewhat but spending on other consumer goods remained strong. Housing starts fell somewhat in May and June from a relatively high level earlier in the year. Business capital spending appears to have remained weak, partly reflecting continuing declines in the energy sector. While fluctuations in energy prices have caused some month-to-month volatility, on average prices and wages are rising more slowly this year than in 1985.
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> The trade-weighted value of the dollar against major foreign currencies has continued to decline since the July 8-9 meeting of the Committee. The U.S. merchandise trade deficit in the second quarter appears to have been about unchanged from the first quarter. The value of total exports and of total imports remained about the same in the two quarters, although the value of oil imports continued to fall in the second quarter while that of non-oil imports rose further.
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> Growth of M2 and especially of M3 picked up in July, lifting expansion of these two aggregates for the year through July well into the upper portion of their respective ranges established by the Committee for 1986.

In July M1 continued to grow at a rate close to the very rapid pace of the second quarter. Expansion in total domestic nonfinancial debt remains appreciably above the Committee's monitoring range for 1986. Short-term interest rates have declined somewhat since the July meeting of the Committee, while most long-term interest rates are about unchanged to slightly lower on balance. On July 10, the Federal Reserve Board approved a reduction in the discount rate from 6-1/2 to 6 percent.

The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at the July meeting to reaffirm the ranges established in February for growth of 6 to 9 percent for both M2 and M3, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth of M1 over the remainder of the year will depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year, the Committee recognized that the increase in total domestic nonfinancial debt in 1986 may exceed its monitoring range of 8 to 11 percent, but felt an increase in that range would provide an inappropriate benchmark for evaluating longer-term trends in that aggregate.

For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5-1/2 to 8-1/2 percent for M2 and M3. While a range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognized that the exceptional uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range at the beginning of 1987. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1987.

In the implementation of policy for the immediate future, the Committee seeks to decrease slightly the existing degree of pressure on reserve positions, taking account of the possibility of a change in the discount rate. This action is expected to be consistent with growth in M2 and M3 over the period from June to September at annual rates of about 7 to 9 percent. While growth in M1 is expected to moderate from the exceptionally large increase during the second quarter, that growth will continue to be judged in the light of the behavior of M2 and M3 and other factors. Somewhat greater or lesser reserve restraint might be acceptable depending on the behavior of the aggregates, 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 4 to 8 percent.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Heller, Mrs. Horn, Messrs. Johnson, Morris, Rice, and Ms. Seger. Votes against this action: Messrs. Melzer and Wallich. Absent and not voting: None.

Messrs. Melzer and Wallich were in favor of maintaining the existing degree of reserve pressure. Mr. Melzer continued to be concerned about the impact of further easing on inflationary expectations and the value of the dollar in foreign exchange markets. In addition, he noted that during the intermeeting period the outlook for real economic activity in the second half of 1986 and in 1987 had not deteriorated and perhaps even had improved slightly. Mr. Wallich emphasized that the implementation of unchanged reserve conditions would improve the prospects for significant slowing in monetary growth, thereby reducing the potential for inflation.