Introduction

The U.S. economy in 1980 experienced wide swings in output and employment and a continued high rate of inflation. An exceptionally sharp but unusually short recession in the first half of the year was followed by a rebound during the second half. On balance over the year, the gross national product was little changed in real terms, after a slight increase in 1979. Payroll employment fell with the contraction in production in the first half and despite a subsequent increase was only slightly higher at year-end than at the end of 1979; the unemployment rate rose sharply through May and then changed little.

Large increases in prices of energy in the first half of 1980 and of food in the second half contributed substantially to inflationary pressures. However, beyond these special factors, continuing poor productivity performance and rapidly rising compensation combined to maintain an underlying trend of unit labor costs—a key element in pricing—of more than 9 percent per year. At year-end, continued strong wage demands were in prospect and a renewed surge in prices of energy and foods seemed likely.

Progress toward price stability and reduced inflationary expectations remains a fundamental precondition for sustained and balanced economic growth. Consequently, throughout 1980 monetary policy concentrated on holding growth of money and credit to rates consistent with a damping of inflationary pressures. The Federal Reserve's actions clearly did impose considerable restraint on the aggregate demand for goods and services, even though the growth rates of the monetary aggregates over the four quarters of 1980 were generally near or somewhat above the upper ends of the ranges established by the Federal Open Market Committee early in the year.

Over the course of 1980, the growth of money and credit fluctuated widely, responding to sudden, sharp changes in economic conditions, to the application of selective credit restraints in the spring, and to variations in public expectations about inflation. Interest rates also showed large swings. They moved to record levels in the first quarter when pressures on credit markets associated with Federal Reserve efforts to prevent excessive monetary expansion were combined with heightened fears of accelerating inflation. They then fell sharply in the spring as a steep decline in economic activity and the imposition of the credit restraint program cut into the demand for money and credit. Over the second half of the year, interest rates again trended upward as the System attempted to moderate monetary expansion in the face of a surprisingly swift economic recovery and continued brisk inflation. The change in operating procedures that occurred in October 1979, which shifted the day-to-day focus of System open market operations from the federal funds rate to reserves, may have contributed to a prompter response of market interest rates to emerging shortfalls or overshoots in monetary expansion; however, the large swings in rates last year primarily reflected the unstable economic environment.

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Introduction

Economic activity in the United States increased little on balance during 1981, extending the sluggishness that began in 1979. Over this period, growth in nominal gross national product was constrained by the application of a monetary policy aimed at damping deeply entrenched inflationary pressures. The rate of inflation, which had increased in 1980, slowed appreciably during the course of 1981. By year-end there were indications of more moderate wage and price behavior that could permit sustained progress toward lower rates of inflation in an environment of more satisfactory economic performance.

The rebound in economic activity that began in mid-1980 continued into early 1981, but aggregate demand soon leveled out, and in the final quarter of the year real gross national product turned down sharply. Payroll employment, which had been rising moderately, declined in the fourth quarter to a level only slightly above that of a year earlier, and the unemployment rate at year-end was close to the highest since World War II.

Abundant agricultural supplies, combined with weak demand, caused inflation in food prices to ease significantly in 1981. The stability of petroleum markets after the initial effect of the decontrol of oil prices also contributed to a deceleration in the overall price level as the year progressed. More fundamentally, the lengthening period of economic slack began to reduce rates of price increase in markets for many goods and services.

Damping of inflation and inflation expectations continued to be the principal objective of monetary policy in 1981. To this end, the ranges established for the monetary aggregates by the Federal Open Market Committee provided for a slower expansion in money and credit than in 1980. Over the four quarters of 1981, growth of the narrow money stock fell short of its target range, but growth of the broader measures exceeded the upper ends of their ranges. These disparate movements were attributable largely to efforts by the public to trim holdings of narrow money, especially in view of the increasing availability and popularity of financial assets paying market-related rates of interest and included in the broader measures of money.

Interest rates remained unusually high and volatile in 1981. Short-term rates were close to record levels at the start of the year and, after a moderate decline, returned to about those levels in late spring. But as the economy weakened and reserve positions eased, short-term rates dropped sharply. In contrast, long-term interest rates remained on a generally upward course throughout the year, in large part reflecting continued concerns in financial markets about huge current and prospective federal deficits and the difficulties of achieving progress against inflation in such circumstances.

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Introduction

Production and employment in the United States declined appreciably during 1982 as the economy continued the difficult transition from inflation to price stability. Most broad price indexes rose less than 5 percent over the year, about half the increase in 1981. The improved price performance was attributable in part to generally weak product markets, exceptionally good harvests, and a surplus of oil in world markets. But more fundamental improvement was evident also as underlying trends in wages began to reflect more fully the progress on the price front as well as domestic and international competitive pressures; with businesses aggressively acting to strengthen productivity, unit labor costs in the nonfarm business sector rose only about 4¾ percent. The rise in the foreign exchange value of the dollar contributed to the moderation in inflation by reducing import prices, but the effect on export and import volume of the decline in the competitive position of the United States in world markets was a source of weakness in domestic economic activity.

Real disposable income edged up over the four quarters of the year, despite a decline in real gross national product. The tax cut in mid-1982 and the increase in transfer payments more than offset the weakness in wages and salaries. Purchases of homes, automobiles, and other durable goods were constrained by the high cost of financing as well as by the limited improvement in spendable real income. In addition, faced with reduced sales volume, low profit margins, and high rates of unused capacity, businesses cut investment spending and liquidated inventories. Industrial production fell sharply in 1982, forcing widespread layoffs, and employment dropped throughout the year. The overall rate of civilian unemployment reached a postwar high of 10.8 percent at the end of the year.

The principal objectives for monetary policy in 1982 were to maintain the financial discipline necessary to achieve further progress toward price stability and, at the same time, to foster conditions conducive to the development of a sustained recovery in economic activity. Accordingly, the Federal Open Market Committee adopted target ranges that provided for some slowing in the underlying growth of the monetary aggregates from their rates of expansion in 1981. As the year progressed, however, the necessity arose to tolerate growth above the upper limits of those ranges to accommodate unusual demands for liquid assets; to have maintained growth within the original targets in such circumstances would have exacerbated recessionary tendencies in the economy. Over the four quarters of 1982, each of the aggregates did, in fact, exceed its targeted range. The overshoot for M1 was especially large; the bulk of the increase was in other checkable deposits, which rose 34 percent over the year. In the fourth quarter, substantial inflows from maturing all savers certificates were superimposed on already strong demands for liquidity, and M1 rose at an annual

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rate of 13 percent. In anticipation of this development and of distortions that would be associated with the introduction of money market deposit accounts in December, the Committee in October shifted its focus to the broader aggregates in implementing its policy objectives.

Credit flows increased in 1982, as stepped-up borrowing by all levels of government more than offset reductions in financing by the private sector. Interest rates remained relatively high, but declined significantly in the third quarter. By the end of the year, nominal interest rates across the maturity spectrum had in most cases reached the lowest levels in more than two years. Mounting evidence of a slowing in underlying inflation might well have produced still larger declines in long-term rates but for the threat of widening federal deficits.

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Introduction

Conditions in the national economy took a decided turn for the better in 1983. Real gross national product rose 6 percent over the four quarters of the year, close to the experience during the first years of past cyclical recoveries but well above earlier projections. Rising production spurred gains in employment large enough to reduce the unemployment rate by 2½ percentage points over the course of the year. At the same time, most broad measures of prices and wages showed further progress toward lower inflation. In short, the performance of the economy in 1983 suggested attainment of the immediate objective of the Federal Reserve: permitting sufficient growth in monetary and credit aggregates to foster a solid economic recovery without encouraging developments that would rekindle inflationary pressures.

Each of the monetary and credit aggregates finished the year within or close to the ranges set by the Federal Open Market Committee. Achievement of these growth rates and the broader goals of the Federal Reserve was brought about by relatively small changes in the reserve position of the banking system and was accompanied by generally stable conditions in financial markets. Interest rates fluctuated far less than in the previous few years. Moreover, although most interest rates rose moderately during the year as the economic recovery progressed, interest rates on average were substantially lower in 1983 than in 1982. For example, rates on level-payment home mortgages averaged nearly 3 percentage points below their 1982 levels; business borrowing costs also declined significantly.

But success cannot be measured by performance during any one year, and in some respects the first year of recovery, which began in the context of excess capacity and high unemployment, provided the most favorable environment for combining economic growth with progress toward price stability. The more stringent and meaningful test will come as we seek to maintain the momentum of expansion and the progress toward stability while the margin of unemployed resources diminishes further.

Several areas of concern remained at the close of 1983. Despite the marked improvement in labor market conditions, unemployment continued to be unacceptably high. In addition, the federal deficit showed a sharp and worrisome increase in 1983. The borrowing necessary to finance the deficit, combined with continuing huge prospective credit demands by the federal government, exerted pressures on market interest rates. These pressures offset the effects of lower inflation and other factors, and thereby tended to temper the expansion of interest-sensitive private sectors of the economy.

The large federal deficit and associated high domestic interest rates helped induce sizable inflows of foreign capital into the United States

NOTE. This discussion of economic and financial developments in 1983 is adapted from the *Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978* (Board of Governors, February 1984).

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throughout the year and contributed to a further rise in the exchange value of the dollar. The strong dollar, in turn, put pressures on industries facing competition from imports and, in an environment of sluggish economic growth in other countries, made it difficult for U.S. industries to sell their products abroad. Consequently, imports increased dramatically relative to exports; this shift significantly moderated the growth in domestic output.

The international debt situation remained a major concern in 1983. Some countries with serious debt problems made considerable progress in formulating and implementing internal adjustment policies, and they continued to receive a moderate flow of new financing. Nonetheless, historically high interest rates in the United States placed heavy burdens on the many developing countries with outstanding debt concentrated in dollars.

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Introduction

Nineteen eighty-four was another year of substantial economic growth in the United States. Production and employment gains were large, making the expansion of the last two years the strongest cyclical upswing since the early 1950s. Moreover, the continued vigor of the economy was accompanied by signs of some further lowering of inflationary expectations. Aggregate price measures rose about 4 percent in 1984, about the same as during the two preceding years. While prices of services continued to rise 5 to 6 percent, prices of many goods were relatively flat, and underlying wage trends seemed to be moderating.

Among the monetary and credit aggregates, growth rates of M1 and M2 were well within the target ranges established by the Federal Reserve, but growth rates of M3 and domestic nonfinancial debt exceeded their ranges. Credit growth in 1984 was the most rapid on record and much larger relative to the expansion of gross national product than historical trends would have suggested.

The strong gains in overall activity during the year drew attention away from a number of continuing problems, but those problems are nonetheless real and serious. The overall rate of unemployment is still uncomfortably high, and joblessness among certain groups—for example, teenagers and blacks—remains well above the average. Sectors of the economy facing intense competition from abroad, such as agriculture and certain mining and manufacturing industries, have not participated in the rapid economic expansion and have been under strong financial stress. Strains also remain evident among financial institutions: the quality of loan portfolios at some depository institutions has deteriorated, and the earnings of thrift institutions remain constrained by low-yielding assets accumulated in earlier years. Although it was not an impediment to economic expansion in 1984, the exceptionally rapid growth in credit has meant that many households and businesses have accumulated substantial indebtedness, often in short-term or variable-rate forms that make borrowers especially vulnerable to unexpected economic developments.

Many of the problems afflicting particular industries have causes and complications that, at least in part, must be handled in direct and specific ways. But it is also evident that the enormous imbalances in our federal fiscal posture and in our trade and current account positions have aggravated the problems and made constructive solutions to them much more difficult. In an expanding economy requiring additional private credit, the need to finance the large federal deficits has contributed to the pressures that have held real interest rates at historically high levels. The failure to deal with budgetary deficits also has sustained doubts in the minds of

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the public about the ability of the government to continue to curb inflation over the long run.

The large federal deficits are mirrored in our external imbalance. The comparatively high real rates of return offered on dollar-denominated assets have attracted many foreign investors, and U.S. lending abroad has been reduced. Other forces stimulating capital inflows have been at work as well, including political and economic uncertainties in other countries and the relative stability and vigor of our economy. The shift in capital flows has supplemented domestic saving and helped finance the federal government deficit and private investment. But, at the same time, the strong demand for the dollar has driven its value on foreign exchange markets to extremely high levels. As the dollar has appreciated, the demand for our exports has suffered and our purchases of imported goods have increased dramatically; the result has been strong competitive pressures in a number of sectors and calls for protectionist measures. Moreover, the sizable capital inflows have led to mounting financial claims of foreigners that the nation must be prepared to deal with in future years through reducing imports or increasing exports, either of which will lower domestic consumption.

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