Overview: Monetary Policy and the Economy in 1997

The U.S. economy turned in another excellent performance in 1997. Growth was strong, the unemployment rate declined to its lowest level in nearly a quarter-century, and inflation slowed further. Impressive gains were also made in other important respects: The federal budget moved toward balance much more quickly than almost anyone had anticipated; capital investment, a critical ingredient for long-run growth, rose sharply further; and labor productivity, the ultimate key to rising living standards, displayed notable vigor.

Among the influences that brought about this favorable performance were the sound fiscal and monetary policies that have been pursued in recent years. Budgetary restraint at the federal level has raised national saving, easing the competition for funds in capital markets and thereby encouraging greater private investment. Monetary policy, for its part, has sought to foster an environment of subdued inflation and sustainable growth. The experience of recent years has provided additional evidence that the less households and businesses need to cope with a rising price level, or worry about the sharp fluctuations in employment and production that usually accompany inflationary instability, the more long-term investment, innovation, and enterprise are enhanced.

The circumstances that prevailed through most of 1997 required that the Federal Reserve remain especially attentive to the risk of a pickup in inflation. Labor markets were already tight when the year began, and nominal wages had started to rise faster than previously. Persistent strength in demand over the year led to economic growth in excess of the expansion of the economy's potential, intensifying the pressures on labor supplies. In earlier business expansions, such developments had usually produced an adverse turn in the inflation trend that, more often than not, was accompanied by a worsening of economic performance on a variety of fronts, culminating in recession.

Robust growth of spending early in the year heightened concerns among members of the Federal Open Market Committee (FOMC) that growing strains on productive resources might touch off a faster rate of cost and price rise that could eventually undermine the expansion. Financial market participants seemed to share these concerns: Intermediate- and long-term interest rates began moving up in December 1996, effectively anticipating Federal Reserve action. When the FOMC firmed policy slightly at its March 1997 meeting by raising the intended federal funds rate from 5¼ percent to 5½ percent, the market response was small.

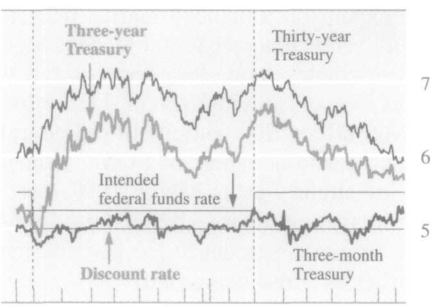
The economy slowed a bit during the second and third quarters, and inflation moderated further. In addition, the progress being made by the federal government in reducing the size of the defi-

NOTE. The discussion here and in the next chapter is adapted from *Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978* (Board of Governors, February 1998).

cit was becoming more apparent. As a consequence, by the end of September, longer-term interest rates fell ¾ percentage point from their peaks in mid-April, leaving them about ¼ percentage point below their levels at the end of 1996. The decline in interest rates, together with continued reports of brisk growth in corporate profits, sparked steep increases in equity prices between April and September.

Even with a more moderate pace of growth, labor markets continued to tighten, generating concern among FOMC members over this period that rising costs might trigger a rise in inflation. Consequently, at its meetings from May through November, the Committee adopted directives for the conduct of policy that assigned greater likelihood to the possibility of a tightening of policy than to the possibility of an easing of policy. Even though the Committee kept the nominal federal funds rate unchanged, it saw the rise in the real funds rate resulting from declining inflation expectations, together with an increase in the exchange value of the dollar, as providing some measure of additional restraint against the possible emergence of greater inflation pressures.

Selected Interest Rates



NOTE. Small tick marks refer to dates in 1996 and 1997 on which the Federal Open Market Committee held scheduled meetings. Dashed lines indicate dates of meetings at which the Committee announced a monetary policy action: January 31, 1996, and March 25, 1997. The data are daily.

In the latter part of the year, developments in other parts of the world began to alter the perceived risks attending the U.S. economic outlook. Foreign economies generally had seemed to be on a strengthening growth path at midyear. But over the remainder of the summer and during the autumn, severe financial strains surfaced in a number of economies in Asia, weakening somewhat the outlook for growth abroad and thus the prospects for U.S. exports. The problems these economies encountered generally resulted in severe downward pressures on the foreign exchange values of their currencies; in some cases, steep depreciations occurred despite substantial upward movement of interest rates. Asset values in parts of Asia, notably equity and real estate prices, also declined appreciably, leading to losses by financial institutions that had either invested in those assets or lent against them; nonfinancial firms began to encounter problems servicing their obligations. In many instances the debts of nonfinancial and financial firms were denominated in dollars and unhedged. Concerted international efforts to bring economic and financial stability to the region were under way as the year drew to a close. Meanwhile, economic activity in Japan stagnated, and the weaknesses in the Japanese financial system became more apparent.

The difficulties in Asia contributed to additional declines of ¼ to ½ percentage point in the yields on intermediate- and long-term Treasury securities in the United States between mid-autumn and the end of the year. The decreases were due in part to an international flight to the safe haven of dollar assets, but they also reflected expectations that these difficulties would exert a moderating influence on the growth of aggregate demand and inflation in the United States. In light of the ongoing difficulties in Asia and the possible effects on the United States, the FOMC not only left interest rates unchanged in December but shifted its instructions to the Manager of the System Open Market Account to symmetry between ease and tightening in the near term. The inflation risk from a tight labor market and accelerating wages seemed to be roughly balanced over the near term by the effects of a number of other factors, including the economic weakness in Asia, a slump in the prices of oil and other commodities in the latter part of 1997, and the restraint on import prices from the substantial appreciation of the dollar against most other currencies over the preceding few quarters. ■