PERSPECTIVE ON MONETARY POLICY
Remarks by Robert P. Forrestal, President
Federal Reserve Bank of Atlanta
To the Seminar on Monetary and Fiscal Policy, Vanderbilt University
February 3, 1988

I. Introduction: I've been asked to talk about the Federal Reserve System and monetary policy.

   A. Feel it would be worthwhile to provide some context by looking first very briefly at the range of functions our central bank performs.

   B. Then I'll talk about the mechanics of policy formation and execution.

   C. Finally I'll discuss recent monetary policy actions and the economic factors that will shape monetary policy in the year ahead.

II. Monetary policy is one of the three businesses of the Fed and is, perhaps, the most difficult for the public to grasp.

   A. The Fed's other businesses are providing financial services for banks and supervision and regulation of the activities of bank holding companies and certain commercial banks.

   B. In its financial services businesses, the Fed is involved in and oversees a large portion of the payments system.

      1. This includes clearing checks, and transferring funds and securities electronically.

2. Private clearing systems do net settlements at the Fed.

3. This function involves facilitating the movement of money in our financial system.

4. As this system becomes more complex and as transactions volume grows, we need to keep in mind that the risks of its failure grow as well.

5. The Fed also serves as fiscal agent for the U.S. Treasury.

   a. Maintains the Treasury's "checking account" and clears checks drawn on that account.

   b. Issues and redeems government securities.

C. Supervision and Regulation of commercial banks and bank holding companies is, if anything, increasing in importance in the wake of the deregulatory moves of this decade and the internationalization of financial markets.

1. Banks have acquired several new powers and are asking for still more flexibility in order to enhance their competitiveness against non-regulated institutions.

   a. For example, we are moving toward full national interstate banking;

   b. Other powers, such as the underwriting of certain securities and the sale of insurance, are now allowed in some states and are under consideration for attention in national regulations.

2. At the same time, U.S. banks must compete with foreign institutions that operate in different--and often less stringent--regulatory frameworks.

3. Thus regulators must be careful that either banks or their customers or both are not driven offshore by regulations that are out of step with the changing environment.

4. The Fed's role in defining bank powers is pivotal because it writes regulations that spell out the precise details of federal banking laws enacted by Congress.

    a. As a bank regulator, the Fed decides on, subject to legislative restrictions, the product lines banks may offer.

    b. We can also mandate capital requirements, and we must approve or oppose proposed bank mergers and acquisitions.

5. Along with the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and state banking authorities, the Fed assumes the responsibility of supervising banks.

    a. By regular examinations these agencies determine whether the regulations are being complied with and if banks are operating in a safe and sound manner.

b. The Fed examines all bank holding companies, all state-chartered banks that are members of the Federal Reserve System, and various international banking operations in the United States.

c. We are responsible for supervising and regulating U.S. activities of foreign banks as well as foreign activities of U.S. banks.

d. This type of supervision keeps track of banks by monitoring the competence of management, the quality of their assets, and their levels of capital.

6. It is important to note, however, that regulation can't prevent individual banks from failing--we have no intention of removing one of the ultimate sanctions of the marketplace.

a. Our concern is the industry as a whole rather than single institutions--except, of course, when these might pose some risk to the entire system.

b. Lately the number of bank failures has risen, and in 1987, 184 banks failed--a post-Depression record.

c. These failures occurred in particular among agricultural banks and banks with energy-related assets.

d. The Fed's role here has been to ensure orderly failure and maintain local banking service.

7. Supervision and Regulation has some abstract aspects due to the subjective nature of evaluating bank soundness, but its general principles and practices can be understood along the lines of other regulatory agencies.

D. However, because of the necessarily confidential atmosphere in which monetary policy is decided upon and because the process is complex, many people have little idea of the nature of this third business the Fed conducts.

1. It is a process that engages the energies of a goodly number of system employees who process a great amount of information--both statistically and analytically.

2. And not even experts in the field agree on how it should be conducted or what elements should be taken into consideration in deciding upon a course of action.

3. It is only one tool of macroeconomic policy and yet people expect us to achieve multiple targets--fast growth, low inflation, low unemployment.

4. For this reason, it tends to be controversial, and the Fed is surrounded by critics ranging from the Congress to economists and journalists.

E. I hope to leave you with an objective view of the process and how it fits into the other duties of the Fed, and that way if you become one of our critics, at least you will have a degree of understanding on which to base your objections--unlike some of the Fedbashers we read about these days.

III. Brief overview of System

A. As you've probably discussed in your classes on money and banking, the Federal Reserve System is best understood as having a dual nature that makes it at once public and private in its operations

1. This dual nature is partially reflected in the differences between the Board of Governors in Washington and the District Banks like ours in Atlanta.

2. The Board members are appointed by the President with the advice and consent of Congress; hence, the System has a public service component.

3. The District Banks are organized along the lines of private corporations.

4. They are governed by their own boards of directors and sell services to banks through our financial services business.

B. Though the more private of the Fed's operations take place at the District level, the public service activities--supervision and regulation of banks and monetary policy formation are jointly carried out by the Board and the District Banks.

IV. Monetary Policy Formation and Implementation

A. Monetary policy is one such jointly administered function.

B. Through monetary policy, the Fed seeks to influence anticipated economic activity by affecting demands for and supplies of money and credit.

1. Monetary policy decisions are made as to how much, if at all, pressure on bank reserve positions should be increased or decreased.

2. The Fed has three tools for implementing its strategy, all of which have their first impact on banks by affecting the cost or the quantity of reserves in the market.

   a. Banks must hold reserves as a percentage of their deposit liabilities.

   b. Clearly if reserves are made more available, banks will be encouraged to lend out more funds, thus expanding the supply of money and credit in the economy, and vice versa.

3. One tool is is the power to change the reserve requirements.

   a. By forcing banks to hold a larger percentage of their deposits on reserve, the Fed would clearly restrict banks' capacity to lend money and extend credit.

b. However, this is a rather blunt or extreme tool and is rarely used as a short-term measure.

4. The best-known tool we use is the discount rate, which is the rate of interest charged to banks who need to borrow from the Fed to make short-term adjustments to their reserve positions.

   a. Generally the higher the rate is, the more costly it is for banks to borrow reserves to meet reserve requirements.

   b. A rise in the discount rate, then, encourages tighter (closer) reserve management and leads to a slower rate of bank loan expansion.

   c. On the other hand, when the Fed lowers the discount rate, commercial banks can have more funds available to lend.

   d. This tool is the one over which directors of the district banks have the most influence because they can propose changes in the discount rate at any time to the Board of Governors.

   e. The press pays special attention to the discount rate because increases or decreases have a direct and immediate effect on the cost of bank reserves.

C. On a day-to-day basis, open market operations is the most significant of the three policy tools.

1. These operations consist of buying and/or selling large quantities of government securities--either on an outright basis or for short periods of time.

   a. When the Fed adds to its holdings of securities it pays for them by crediting banks with reserves.

   b. Similarly, a sale of securities drains reserves.

2. You need to keep in mind that some--in fact most--of our open market activity is seasonal.

3. We generally provide more reserves at Christmas time, for example, because merchants and shoppers demand more money at that time.

4. But a component of open market operations is policy-oriented and seeks to affect pressures on bank reserve positions.

D. Any policy has short-term implications--mostly in the money market.

1. When we provide banks with more reserves than they need, we are easing policy.

2. As in the cases of the reserve requirement and the discount rate, when pressure of banks reserve positions is eased they become more willing to supply credit and interest rates fall.

3. Conversely when we provide fewer reserves, we push them toward borrowing at the discount window.

4. In time, this affects economic activity.

E. But Fed policy is not the only factor influencing the economy at any given time.

1. The government's fiscal policy--budget and taxation--carries its own consequences;

2. In our global economy, the policies of foreign governments have an impact on the U.S. economy, albeit small.

3. And other factors whose effect is very difficult to foresee, such as oil supply shocks and demographic shifts, also add to the mix.

F. Thus two major points about the process of devising this strategy bear emphasizing at the outset.

1. The environment of the policy maker is dominated by uncertainty.

a. From the standpoint of economic research, one can project ideal conditions and devise models to deal with them;

b. But in the real world of markets, no model can cover all the myriad possibilities that might occur.

2. Successful policy reflects dealing with uncertainty in the short run in a way that makes sense in the long run.

   a. In other words, we maintain a vision of the economy in terms of optimal performance under the conditions we project 6 months to 18 months down the road;

   b. Then enact day-to-day decisions with that vision in mind.

3. Thus I'll try to give you a sense of how our daily, weekly, and monthly decisions fit together--even though on the surface they may appear to conflict.

G. Long-term objectives are desirable values for real income--usually expressed in terms of real gross national product (GNP)--and for employment and prices.

1. In general, we want GNP to grow as much as possible without bringing on inflation; and we want unemployment to be as low as possible.

2. These are objectives that few could disagree with--kind of like motherhood.

3. And in general, we work on the assumption that the more ease there is in the amount of available money and credit, the more stimulus is provided for GNP growth, and the reduced unemployment results growth.

4. Excess ease in money tends to be associated with inflation.

   a. If the economy is overstimulated, excess demand drives up prices.

   b. So the Fed's policy makers must walk a very thin line in striking a balance among these objectives.

5. Thus making monetary policy is rather like flying an airplane in the fog--you have a good idea where you want to go and you have instruments to help you get there, but you can't see your objective clearly or anticipate hidden obstacles that might suddenly force you to correct your course.

H. The "instruments" that allow us to plan long-term strategy are barometers of the relative ease or tightness of money in the economy.

1. These barometers provide information on how the economy is doing before data on ultimate objectives--GNP, etc.--are available.

2. Policy makers assume that the relationship between these barometers and ultimate policy objectives are stable and adjust policy instruments in a way that generates desired behavior in the barometers.

3. During the late seventies, one group of barometers--the monetary aggregates, M1, M2, and M3--became institutionalized as intermediate targets for monetary policy.

a. The Humphrey-Hawkins legislation of 1978 requires the Fed Chairman to report ranges for growth of the three Ms in his semiannual testimony to Congress.

b. Economists of the monetarist persuasion believe that monetary policy can be linked to the monetary aggregates, especially M1, in a fairly mechanical way, and for a while Fed policy was structured somewhat along that line of reasoning.

4. Because of deregulation and financial innovation, these measures no longer provide reliable guidance.

5. The growth of interest-bearing transactions accounts like NOW and money-market accounts in the mid-eighties, however, M1--which had been the most important of these targets--stopped behaving in the way it previously had and lost much of its value as a barometer.

6. For this reason, in 1986 we stopped setting targets for M1.

7. We still watch M1, of course, and still set targets for M2 and 3.

8. The monetary aggregates still provide a valuable vehicle for communicating our objectives with Congress and the nation.

9. They cannot be used as the predominant intermediate target by which to put long-term goals into practice, however.

I. Instead, policy is determined through an extensive examination of current and projected economic conditions--including the monetary aggregates and interest rates along with other indicators.

V. The group that examines information about the economy and sets policy is the Federal Open Market Committee (FOMC).

A. FOMC members are the Board of Governors and the presidents of the District Banks.

1. Along with the Board, the the president of the New York Fed, where policy is effected, and 4 of the remaining 11 Fed presidents vote on a rotating basis on policy decisions.

2. I will be a voting member again this year.

3. All presidents participate in policy discussions, however, and provide the regional input that makes the System representative of the nation as a whole.

B. At its meetings, the FOMC assesses an elaborate forecast of the economy prepared by the Board's staff.

1. It is based on a large scale model of the economy--but we also need to consider other possible factors--exogenous ones--that are not predictable.

a. What will Congress do.

b. Will OPEC successfully curtail production?

2. A full-scale simulation is done about 4 times a year and the estimates are updated prior to each FOMC meeting in response to new data.

   a. The simulations project for a period of 4 to 8 quarters.

   b. They usually assume an unchanged monetary policy during the forecast period, although the impacts of alternative scenarios is readily predictable.

3. The forecast indicates the income, employment, and inflation that are expected to be consistent with a particular policy and assumptions about exogenous factors.

4. Twice a year there is a full-scale look at the outlook 2 years ahead.

C. As I mentioned, all reserve bank presidents participate--along with their research directors--whether or not it is their turn to vote.

1. District bank research staffs conduct their own discussions of the economy prior to the FOMC meeting.

   a. We debate the exogenous variables and ask a lot of "what if" questions

b. We also have a small mathematical forecasting model that projects GNP, employment, and prices.

c. We conclude with a go-round at which each economist expresses his thoughts about what policy option should be exercised.

d. My research director and I carry this input with us to Washington as we evolve our position.

2. At FOMC meetings there is an extensive discussion of the district banks' forecasts along with discussion of the Board's forecast.

3. The discussion is open with the same kinds of "what if" questions coming up.

D. At each meeting, the FOMC typically reaffirms the objectives for the monetary aggregates.

1. These ranges reflect the leverage the FOMC wants to exert on the economy in the long run.

a. For several years--starting in the late 1970s up until 2 years ago the FOMC steadily reduced the ranges for the aggregates to signal its desire to reduce inflation.

b. However, since inflationary pressures develop or abate slowly, the committee was not necessarily indicating that it expected to achieve lower inflation in the months ahead.

2. As I mentioned a moment ago, in recent years the relationship between the aggregates and the economy has changed.

3. It does appear, however, that money demand, for example, is more sensitive to interest rates than prior to deregulation.

4. Since there are so little data available for the post-deregulation period, our estimates of money demand are still tenuous.

   a. Consequently, we did not specify a range for M1 in 1987.

   b. Ranges for M2 and M3 were set at 5 1/2 to 8 1/2 percent compared to 6 to 9 percent for the year before.

   c. At our meeting next week, we will consider 1988 ranges.

E. Because of uncertainties about the behavior of money and because it is an intermediate as opposed to a final objective, the FOMC does not aim to achieve the growth within the specified ranges irrespective of what is happening in the economy.

   1. At times, the FOMC has indicated that it is willing to accept growth that is above or below the ranges because actions to achieve growth within the range would run counter to the short-term thrust of monetary policy.

2. In the fall of 1982, for example, we purposely did not respond to above range money growth.

   a. The country was in the deepest recession of the post-World War II era and actions to restrain money growth would have meant greater pressure on bank reserve position and rising interest rates.

   b. I'm sure you'll agree that was the right decision.

3. This past year M2 ended up below its specified range, while M3 was at the very bottom of its range.

   a. While policy did ease in late October--which I'll get to in a moment--our earlier move to a more restrictive stance was taken in light of estimates showing that economic growth was becoming more rapid than was likely to prove sustainable, thereby creating the potential for inflation to accelerate.

   b. The rise in market rates of interest in the spring and summer of 1987 negatively impacted on money growth.

F. Thus, in the short run, we feel reasonably comfortable in taking action that--as I noted--may, on the surface, seem to conflict with long range objectives.

G. This brings me to the next step in policy formulation--developing a short-term response function to guide the manager of the System Open Market Account in

New York.

1. The manager, who is an official at the New York Fed, reports directly to the FOMC.

2. He and his staff--about 60 people all told--are responsible for executing policy decisions.

3. As I noted we may be willing, in the short run, to tolerate more rapid or slower growth in monetary aggregates than we have specified.

4. But that is only a portion of the short-run response--since there are an infinite number of ways to reach long-run goals.

H. For example, if we expect income growth to accelerate to an unsustainable pace, we might want to make policy more restrictive to prevent a build up in inflation.

1. Still, we have various ways of doing this.

   a. Could move to restrain bank reserve growth now;

   b. Could restrain growth a little bit now, raising the possibility that more might need to be done later.

2. Staff shows these alternatives to the FOMC, and members are thus permitted to incorporate their own judgements of the economy into their

decision:

a. Those who are fairly certain the economy is accelerating would choose more restraint now.

b. Those less certain about the degree of acceleration could opt for gradual change.

c. Those who disagree with the forecast could favor no change or even an easing.

3. Each alternative contains short-run specifications for the manager of the System Open Market Account at the New York Fed.

a. These specify a reaction function for the Desk--one that is related to the policy thrust the committee has chosen.

b. They also condition the response to incoming information--this is basically like letting a pilot alter the course as barometers give information.

4. In some senses, these specifications define the conditions under which the System will supply reserves.

a. For example, the Committee may choose a no-change policy--but be somewhat more willing to tighten than to ease.

b. Thus they would want the manager to react to any signs that economic growth or price pressures were accelerating but to make no change unless signs of unexpected weakness were widespread.

c. In regard to price pressures they might be especially concerned about pressures on the dollar in the foreign exchange markets and use that as a conditioning factor for the manager's response.

5. Suppose the Committee had selected, as it did in August of this past year, a modest firming of policy--to be extended under the conditions noted above.

a. The manager would undertake to increase the pressure on bank reserve conditions.

b. He would seek to supply reserves at a pace that was slower than the demand for reserves was expanding--thus forcing banks to meet reserve needs at the discount window.

c. But, ordinarily, banks must use the discount window only for temporary adjustments--they can't keep coming back.

d. So in fairly short order, they begin to bid more aggressively for reserves in the overnight Federal funds market--driving the funds rate up.

e. Ordinarily, the FOMC will indicate how much leeway the manager has in increasing pressure on bank reserve positions, and it also specifies a range of allowable variation in the Federal funds rate.

f. A firming of pressures on reserve positions will spill over to other interest rates thereby affecting the demand for money and credit--and the economy.

6. The impact of such actions is greatest on short term rates of interest.

a. If, for example, market participants thought that we were being "too tight" and that the economy would weaken significantly, then long-term interest rates might decline relative to short term ones and the yield curve would flatten.

b. If they thought we were "too easy" the yield curve would get steeper, reflecting expectations that interest rates would need to rise by more later on.

I. Procedures also allow for flexibility.

1. Clearly, after the decline of the stock market, the manager was able to quickly shift direction and provide for increased demands for liquidity.

2. Each FOMC directive contains provisions for the FOMC to be consulted by the manager if important or unexpected developments arise in the period between meetings.

J. Summary of monetary policy procedure:

1. FOMC evaluates economic outlook, sets annual targets for growth consistent with its ultimate objectives for the economy. Formal ranges for M2 and M3 are agreed upon twice a year.

2. At each meeting, Committee selects a profile for policy that derive from short-term assessments and that seeks to be responsive to unfolding information on the economy.

3. Using this, it establishes a response function for the Manager of the System Open Market Account.

VI. How an FOMC meeting works.

A. Having discussed the mechanics of monetary policy in this rather abstract sense, I'll now try to provide a picture of how committee meetings work in a more concrete, human sense.

B. Open Market Committee meetings have been held in some form since the 1920s, but the FOMC as we know it today was established by the Banking Act of 1935.

C. Meetings are held six times a year--the next meeting will be held Tuesday of next week.

1. Members of the Committee gather around a large table in the Board's

office building on Constitution Avenue in Washington with Board staff aides. A limited number of advisers line the outside of the room.

2. The Chairman of the Board of Governors--Alan Greenspan presently--enters at 9:30 and convenes the meeting.

3. Chairman asks to hear from the Foreign Desk.

4. Manager for Foreign Operations from the New York Fed describes developments in foreign exchange operations.

   a. I have not mentioned these in my discussion so far, in that they are undertaken in concert with the Treasury and often other central banks as well.

   b. Any exchange market intervention is initially sterilized, though the behavior of the dollar may, as I did note, elicit a policy response.

5. There is usually discussion and, afterward, the manager's operations are typically approved.

6. Chairman turns to the Manager for Domestic Operations who discusses open market operations and financial market developments since the previous meeting.

7. There is again a question and answer time and approval of operations.

8. Board staff director of research summarizes the staff outlook for the U.S. economy and highlights risks and uncertainty.

9. The presentation would seem deceptively simple to one not aware of the thousands of man-hours necessary to prepare it.

   a. While the staff starts with a large structural model of the economy, estimates are adjusted on the basis of information that cannot be incorporated mechanically.

   b. For example, even after the dollar had fallen significantly, exporters to the U.S. were willing to reduce margins to maintain market share.

   c. Thus estimates of how the dollar was affecting import prices, domestic prices, and imports were likely to be off.

   d. It is difficult to model this.

   e. The staff forecast is written up in what is called the "Green Book," which we receive in Atlanta the Thursday prior to the meeting.

10. As his presentation comes to an end, several members nod unobtrusively to the secretary, who notes for the Chairman's reference that they wish to speak.

    a. A lengthy period of questioning and debate follows.

b. A district president may mention observations from his own district that contradict the staff's presentation.

c. He may also refer to his own staff's forecast and what differences it has.

(1) In Atlanta, for example, we look at both a judgmental forecast and one generated by a Bayesian vector autoregressive model.

(2) My own staff prepares a "Gold Book" for me describing their outlook and policy recommendations.

d. Someone else may point out historical cases that have similar outlines or cases that have different ones for that matter.

e. Others may refer to conversations with business leaders indicating their outlook and plans for their companies.

11. The meeting usually breaks around 11:00, and individual conversations continue over coffee.

12. When the group convenes again, the Director for Monetary Policy presents the FOMC with three policy alternatives.

13. These have been written up in a "Blue Book" that I receive the Saturday

or Sunday before the meeting.

14. Then it is time to settle on the monetary policy course of action for the next six weeks.

    a. Each of the 19 people at the table has the opportunity to comment on the information presented that morning and on the viewpoint to which his own preparation has brought him.

    b. Presidents and Governors may suggest changes to the policy alternatives.

    c. There is no particular order to the comments; can be quickly concluded, or other times takes several hours, depending on how much agreement there is.

    d. The Chairman seeks to derive a consensus about policy from the views that are expressed.

    e. There can be a number of informal tallies--sort of asking voting members if they can "live with" a particular policy as opposed to being strongly in favor or opposed.

15. Governors and voting members cast votes according to roll call.

16. Dissenting votes carry an explanation that is recorded in the minutes and are released later.

17. Meeting adjourns.

D. Each president in turn is charged with monitoring the Fed's open market operations.

   1. Assisted by his staff, he will participate each day in a conference call with the Director for Monetary Policy and the Open Market Account Manager in New York and any Governors that may want to sit in.

   2. The manager typically discusses current financial market conditions and his proposed action for the day.

   3. This experience adds a great deal to the perspective of each participant.

VII. Monetary Policy in 1987

A. The results of FOMC meetings are released 13 days after the following meeting.

B. The reason for the lag is to provide the System with flexibility to alter its course of direction if needed.

   1. For example, after the stock market crash, we did have some concern about financial market stability.

2. Announcing our deliberations on this as they progressed would not have been helpful in my view.

C. Reading the records of policy actions taken as printed in the Federal Reserve Bulletin can give you a picture of what data FOMC members considered to be the most relevant economic data during a given period.

D. The most recent meeting that is a matter of public record was the November 3, 1987 meeting.

   1. At that time, the economic outlook changed somewhat, given the extraordinary financial market developments of previous weeks.

   2. However, it was too soon to have data on the economy's response to this.

   3. In its discussion, the Committee generally agreed that the sharp drop in stock prices and still unsettled conditions in financial markets portended weaker economic growth--at least in the near term.

   4. These developments also reduced the risks of any substantial pick up in inflation.

   5. Still, members stressed that while the direction of the adjustment was clear, it was too early to quantify these likely impacts.

E. The Committee reaffirmed the 5 1/2 to 8 1/2 percent ranges for growth in M2 and M3 from fourth quarter 1986 to fourth quarter 1987.

F. For 1988, it agreed to tentative reductions of 1/2 percent--to a 5 to 8 percent growth range for both aggregates.

G. Regarding policy over the weeks ahead, the Committee agreed that it was appropriate to direct operations at maintaining the easier conditions that had emerged on money markets in late October.

1. They also agreed on the need for greater accommodation and flexibility in the manager's day-to-day approach until financial markets settled down.

2. As I noted, the switch to a more accommodative approach occurred when the extent of the market collapse on October 19 became clear.

3. The FOMC recognized that in addition to helping offset the impact of lower stock prices, the decline in interest rates that had developed could also risk greater weakness in the dollar.

4. There were no dissents; they felt this risk was manageable.

VIII. To round out my presentation--and set the tone for monetary policy in the year tc come--I'll conclude with my outlook for the economy in the year ahead.

A. In the year just ended, real GNP grew 2.9 percent on a year-over-year average basis.

1. This rate of expansion helped lower the unemployment rate to 5.8 percent by December, the lowest in eight years.

2. At year's end, prices as measured by the consumer price index were 4.4 percent higher than in December of last year, largely due to he impact of higher energy prices.

B. Looking to 1988, I see a continuation of expansion at a slower pace of 2 percent or a little higher.

1. With decelerating growth, unemployment could possibly rise a little in the first part of the year.

2. Inflation is likely to be about the same as last year.

C. My outlook for continued growth in GNP rests on three areas of strength: continued modest advances in consumption, further gains in capital spending on new equipment, and a fairly significant improvement in the foreign trade sector.

1. Consumer spending is likely to advance, albeit modestly, in 1988, in spite of the stock market crash last fall.

2. The main source of momentum for growth will not be consumption but rather net exports.

a. These have been trending up in real, or inflation-adjusted terms, since late 1986.

b. The dollar's substantial drop in value against foreign currencies makes our goods more attractive to foreigners.

c. This development has boosted production and employment in our manufacturing sector.

d. In addition, Japan has recently begun to stimulate its economy, though West Germany has been slower to do this.

3. Probably the weakest sector of the economy during the coming year will be commercial and residential construction.

4. Government spending will be sort of neutral: the federal budget deficit is likely to increase a little bit in 1988, due to the unwinding of special factors that temporarily increased 1987 revenues.

5. Together these factors suggest that GNP growth will continue in 1988, but not quite as rapidly as in 1987.

D. Turning to inflation, oil prices are likely to stay in their present range or maybe drift a little higher, depending on whether OPEC carries out on its promise to cut production.

1. However, last year's further decline in the dollar should push non-oil import prices up even more.

2. As this happens, the dollar-related increase in domestic manufacturing could exert upward pressure on labor costs.

3. Unemployment is close to the point at which further efforts to stimulate growth result in more wage pressures than job gains.

4. Still, with the economy likely to be a little slower in the first half of the year, inflation should not be any higher than it was in 1987.

E. In all, with slower but still moderate growth in GNP and no acceleration in price increases in the offing, we can look forward to another year of decent economic performance.

IX. I've tried to give a fairly thorough assessment of the monetary policy function at the Fed from defining its place among the three businesses of a Federal Reserve Bank through the mechanics of decision-making to a look at the factors that will influence monetary policy in the year ahead. At this point, then, I'd like to get some input from you and spend the remainder of our time together clarifying issues about which you may have questions or exploring in more detail areas that you would like me to develop for you.