CONDUCT OF MONETARY POLICY

(Report of the Federal Reserve Board pursuant to the Full Employment and Balanced Growth Act of 1978, P.L. 95-523.)

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

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CONDUCT OF MONETARY POLICY

Tuesday, February 20, 1990

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met pursuant to call at 10 a.m. in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Barnard, Hoagland, and Leach.

Also Present: Representatives Roukema and Saiki.

Chairman NEAL. I would like to call this meeting of the Subcommittee on Domestic Monetary Policy to order.

This morning we are pleased to welcome the Chairman of the Federal Reserve Board, Alan Greenspan, for his presentation of the Federal Reserve Semi-Annual Monetary Policy Report to the Congress.

Mr. Chairman, welcome. I want to welcome you and I want to commend you for continuing to follow take the course that you and the other Governors are taking concerning the long-term health of our economy. You must take the long view when all the temptations around here are to take the short-term view of things. Nothing is more important for the future health of our economy than a monetary policy that aims for price stability, which I know you are pursuing. This long view will be very important for the economic well-being of our country for many years to come.

I would like to bring you up to date if I can, on House Joint Resolution 409, our legislation which would set zero inflation as the primary goal, primary function of monetary policy. You have endorsed the legislation in testimony last year before us. Since that time several Nobel prize winning economists have endorsed it, several regional Federal Reserve Bank presidents have endorsed it, and a number of other prominent economists have endorsed this legislation.

Of course, I am delighted by that. I don't know how long it will take, but at some point we have the opportunity of getting the Congress behind this long-term view also. As you well know, if we can achieve price stability and low inflation, we can expect enormous benefits to our economy—the lowest possible interest rates, the maximum sustainable growth in our economy, maximum sustainable employment, maximum sustainable savings and investment and productivity. I think all of these things we want for our economy.

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So I wanted to report to you that we are coming along with our legislation. I wish I could tell you when we will get it passed. I don't know that, but we will certainly keep working on it. I would like to yield at this time to our distinguished ranking Member, if he has any comments to make.

Mr. LEACH. Mr. Chairman, I have no further comments, but I would like to certainly share your views of Mr. Greenspan. We appreciate your coming this morning.

Chairman NEAL. Thank you, sir. Mr. Chairman, we will put your entire statement in the record and would welcome your proceeding as you will.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Well, thank you very much, gentlemen. I certainly appreciate the opportunity to testify today on the Federal Reserve's Semi-Annual Monetary Policy Report to the Congress. My prepared remarks discuss our monetary policy actions and plans in the context not only of the current and projected state of the economy, but also against the background of our longer-term objectives and strategy for achieving them.

The final section of the testimony addresses some issues for monetary policy raised by the increasingly international character of financial markets.

Last year marked the 7th year of the longest peacetime expansion of the U.S. economy on record. Some 2½ million jobs were created, and the civilian unemployment rate held steady at 5¼ percent. Inflation was held to a rate no faster than that in recent years, but unfortunately no progress was made in 1989 toward price stability. Thus, while we can look back with satisfaction at the economic progress made last year, there is still important work to be done.

About a year ago, Federal Reserve policy was in the final phase of a period of gradual tightening, designed to inhibit a buildup of inflation pressures. Interest rates moved higher through the winter, but started down when signs of more restrained aggregate demand and of reduced potential for higher inflation began to appear. As midyear approached, a marked strengthening of the dollar on foreign exchange markets further diminished the threat of accelerating inflation. New economic data suggested that the balance of risks had shifted toward the possibility of an undue weakening in economic activity.

With M2 and M3 below the lower bounds of their annual ranges in the spring, the Federal Reserve in June embarked on a series of measured easing steps that continued through late last year. Across the maturity spectrum, interest rates declined further, to levels about 1½ percentage points below March peaks. Reductions in inflation expectations and reports of a softer economy evidently contributed to the drop in rates in longer-term markets.

The decrease in short-term rates lifted M2 to around the middle of its annual range in the latter part of the year. So far this year, the Federal funds rate has remained around 8¼ percent, but rates on Treasury securities and longer-term private instruments have

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reversed some of their earlier declines. Investors have reacted to stronger-than-expected economic data, a runup in energy prices, and increasingly attractive investment opportunities abroad, especially in Europe.

Monetary policy was conducted again last year with an eye on long-term policy goals, and economic developments in 1989 were consistent with the Federal Reserve's medium-term strategy for reaching them. The ultimate objective of economic policy as I have stated before is to foster the maximum sustainable rate of economic growth. By ensuring stable prices, monetary policy can play its most important role in promoting economic progress.

The strategy of the Federal Open Market Committee (FOMC) for moving toward this goal remains the same—to restrain growth in money and aggregate demand in coming years enough to establish a clear downward tilt to the trend of inflation and inflation expectations, while avoiding a recession.

If past patterns of monetary behavior persist, maintaining price stability will require an average rate of M2 growth over time approximately equal to the trend growth in output. During the transition, the decline of market interest rates in response to the moderation in inflation would boost the public's demand for M2 relative to nominal spending, lowering M2 velocity. M2 growth over several years accordingly may show little deceleration, and it could actually speed up from time to time, as interest rates decline in fits and starts. Hence, the FOMC would not expect to lower its M2 range mechanically each and every year in the transition to price stability.

This qualitative description of our medium-term strategy is easy to state, but actually implementing it will be difficult. Unexpected developments no doubt will require flexible policy responses. Any such adjustments will not imply a retreat from the medium-term strategy or from ultimate policy goals.

Rather, there will be mid-course corrections that to keep the economy and prices on track. The easing of reserve pressures starting last June is a case in point. Successive FOMC decisions to ease operating policy were intended to forestall an economic downturn, the chances of which seemed to be increasing as the balance of risks shifted away from greater inflation.

The FOMC was in no way abandoning its long-term goal of price stability, instead, it sought financial conditions that would support the moderate economic expansion judged to be consistent with progress toward stable prices. In the event, output growth was sustained last year, although in the 4th quarter a major strike at Boeing combined with the first round of production cuts in the auto industry accentuated the underlying slowdown.

On the inflation side, price increases in the second half were appreciably lower than those in the first. Against this background, the Federal Reserve Governors and the Presidents of Reserve Banks foresee continued moderate economic expansion over 1990, consistent with conditions that will foster progress toward price stability over time. At its meeting earlier this month, the FOMC selected ranges for growth in money and debt it believes will promote this outcome.

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My testimony last July indicated the very preliminary nature of the tentative ranges chosen for 1990, given the uncertain outlook for the economy, financial conditions, and appropriate growth of money and debt. With the economic situation not materially different from what was anticipated at that time, the FOMC reaffirmed the tentative 3 to 7 percent growth range for M2 in 1990 that it set last July.

This range, which is the same as that used in 1989, is expected by most FOMC members to produce somewhat slower growth in nominal GNP this year. The declines in short-term interest rates through late last year can be expected to continue to boost the public's demands for liquid balances in M2, at least for a while longer. M2 growth over 1990 thus may be faster than in recent years, and M2 velocity could well decline over the four quarters of the year, absent a pronounced firming in short-term market interest rates.

In contrast with M2, the range for M3 has been reduced from its tentative range set last July. The new M3 range of 2½ to 6½ percent is intended to embody the same degree of restraint as the M2 range, but it was lowered to reflect the continued decline in thrift assets and funding needs now anticipated to accompany the ongoing restructuring of the thrift industry.

The committee's best judgment is that money and debt growth within these annual ranges will be compatible with a moderation in the expansion of nominal GNP. Most FOMC members and other Reserve Bank presidents foresee real GNP growing 1¾ to 2 percent over the year as a whole. Such a rate would be around last year's moderate pace, excluding the rebound in agricultural output from the 1988 drought.

A slight easing of pressures on resources probably is in store. Inflation pressures should remain contained, even though the decline in the dollar's value over the past-half year likely will reverse some of the beneficial effects on domestic inflation stemming from the dollar's earlier appreciation. The CPI this year is projected to increase 4 to 4½ percent, as compared with last year's 4½ percent.

Experience has shown such macroeconomic forecasts to be subject to a variety of risks. Assessing the balance of risks between production shortfalls and inflation pressures in the current outlook is complicated by several cross-currents in the domestic and international economic and financial situation.

One risk is that the weakness in economic activity evident around year-end may tend to cumulate, causing members' forecasts about production and employment this year to be overly optimistic. However, available indicators of near-term economic performance suggest that the weakest point may have passed.

The inventory correction in the auto industry—a rapid one involving a sharp reduction in motor vehicle assemblies in January coupled with better motor vehicle sales—seems to be largely behind us. Industrial activity outside of motor vehicles appears to be holding up. Production of business equipment, where evidence has accumulated of some stability— if not an increase—in orders for capital goods, is likely to support manufacturing output in coming months.

From these and similar data, one can infer the beginnings of a modest firming in economic activity. While we cannot be certain

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that we are as yet out of the recessionary woods, such evidence warrants at least guarded optimism.

There are, however, other undercurrents that continue to signal caution. One that could disturb the sustainability of the current economic expansion has been the recent substantial deterioration in profit margins. A continuation of this trend could seriously undercut the still expanding capital goods market. However, if current signs of an upturn in economic activity broaden, profit margins can be expected to stabilize.

A more deep-seated concern with respect to the longer-run viability of the expansion is the increase in debt leverage. Although the trends of income and cash flow may have turned the corner, the structure of the economy's financial balance sheet weighs increasingly heavily on the dynamics of economic expansion.

In recent years, business debt burdens have been enlarged through corporate restructurings, and as a consequence interest costs as a percent of cash flow has risen markedly. Responding to certain well-publicized debt-servicing problems, creditors have become more selective in committing funds for these purposes. Within the banking industry, credit standards have been tightened for merger and LBO loans, as well as for some other business customers. Credit for construction projects reportedly has become less available because of FIRREA-imposed limits and heightened concerns about overbuilding in a number of real estate markets.

Among households, too, debt-servicing burdens have risen to historic highs relative to income, and delinquency rates have moved up of late. Suppliers of consumer and mortgage credit appear to have tightened lending terms a little. Real estate values have softened in some locales, although prices have maintained an uptrend in terms of the national averages, especially for single-family residences. These and other financial forces merit careful monitoring. While welcome from a supervisory perspective, more cautious lending does have the potential for damping aggregate demand.

It is difficult to assess how serious a threat increased leverage is to the current levels of economic activity. Clearly, should the economy fall into a recession, excess debt service costs would intensify the problems of adjustment. But it is unlikely that in current circumstances strains coming from the economy's financial balance sheet can themselves precipitate a downturn. As I indicated in my prepared text, Mr. Chairman, we expect nonfinancial debt growth to continue to slow from its frenetic pace of the mid-1980's. This should lessen the strain and hopefully the threat to the economy.

Among other concerns, recent events have highlighted the complex interactions between developments in the U.S. economy and financial markets and those in the other major industrial countries. Specifically, the parallel movements in long-term interest rates here and abroad over the early weeks of 1990 have raised questions: To what extent is the U.S. economy subject to influences from abroad? To what extent, as a consequence, have we lost control over our economic destiny? The simple answer to these questions is that the U.S. economy is influenced from abroad to a substantially greater degree than, say, two or three decades ago, but U.S. monetary policy is, nonetheless, able to carry out its responsibilities effectively.

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The post-war period has seen markedly closer ties among the world's economies. Markets for goods have become increasingly, and irreversibly, integrated as a result of the downsizing of economic output and the consequent expansion of international trade. The past decade, in particular, also has witnessed the growing integration of financial markets around the world.

Advancing technology has fostered the unbundling and transfer of risk and engendered a proliferation of new financial products. Cross border financial flows have accordingly accelerated at a pace in excess of global trade gains. This globalization of financial markets has meant that events in one market or in one country can affect within minutes developments in markets throughout the world.

More integrated and open financial markets have enabled all countries to reap the benefits of enhanced competition and improved allocation of capital. Our business can raise funds almost anywhere in the world. Our savers can choose from a lengthening menu of investments as they seek the highest possible return on their funds. Our financial institutions enjoy wider opportunities to compete.

In such an environment, a change in the expected rate of return on financial assets abroad naturally can affect the actions of borrowers or lenders in the United States. In response, exchange rates, asset prices, and rates of return all may adjust to new values.

Strengthened linkages among world financial markets affect all markets and all investors. Just as U.S. markets are influenced by developments in markets abroad, foreign markets are influenced by events here. These channels of influence do not depend on whether a country is experiencing a deficit or a surplus in its current account.

In today's financial markets, the net flows associated with current account surpluses and deficits are only the tip of the iceberg. What are more important are the huge stocks of financial claims—more than $1.5 trillion held in the United States by foreigners and more than $26 trillion of dollar-denominated claims on U.S. borrowers held by U.S. residents. This is in addition to the vast quantities of assets held in foreign currencies abroad. It is these holdings that can respond to changes in actual and expected rates of return.

In recent years we have seen several instances in which rates of return have changed essentially simultaneously around the world. For example, stock prices moved together in October 1987 and 1989, and in 1990 bond yields have risen markedly in many industrial countries.

However, we must be cautious in interpreting such events, and in drawing implications for the United States. Frequently, such movements occur in response to a common worldwide influence. Currently, the world economy is adjusting to the implications of changes in Eastern Europe, where there are tremendous new opportunities to invest and promote reconstruction and growth. Those opportunities, while contributing to the increase in interest rates in the United States, also open up new markets for our exports.

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Moreover, despite globalization, financial markets do not necessarily move together—they also respond to more localized influences. Over 1989, for example, bond yields in West Germany and Japan rose about a percentage point, while those in the United States fell by a similar amount. The contrast between 1989 and 1990 illustrates the complexity of relationships among financial markets.

Interactions can show through in movements in exchange rates as well as interest rates, and changes in the relative prices of assets depend on a variety of factors, including economic developments and inflation expectations in various countries as well as monetary and fiscal policies both here and abroad.

The influence of economic policies abroad and other foreign developments on the U.S. economy is profound, and the Federal Reserve must carefully take them into account when considering its monetary policy. But these influences do not fundamentally constrain our ability to meet our most important monetary policy objectives.

Developments within U.S. financial markets remain the strongest influence on the asset prices and interest rates determined by those markets and, through them, on the U.S. economy. Exchange rates absorb much of the impact of developments in foreign asset markets, permitting U.S. interest rates to reflect primarily domestic economic conditions.

Exchange rates influence the prices of products that do, or can, enter into international trade. Such factors can bring about changes in the composition of production between purely domestic goods and services and those entering international trade, and they can affect aggregate price movements for a time.

However, the overall pace of spending and output in the United States depends on the demands upon all sectors of the U.S. economy taken together. And our inflation rate, over time, depends on the strength of those demands relative to our ability to supply them out of domestic production. Because the Federal Reserve is able to affect short-term interest rates in U.S. financial markets, it is able to influence the pace of economic activity in the short run and inflationary pressures longer term. To be sure, monetary policy must currently balance more factors than in previous decades. But our goals are still achievable.

Monetary policy is only one tool, however, and it cannot be used successfully to meet multiple objectives. The Federal Reserve, for example, can address itself to either domestic prices or exchange rates but cannot be expected to achieve objectives for both simultaneously. Monetary policy alone is not readily capable of addressing today's large current account deficit, which is symptomatic of underlying imbalances among saving, spending, and production within the U.S. economy.

Continued progress in reducing the Federal deficit is a more appropriate instrument to raise domestic saving and free additional resources for productive investment. The long-term health of our economy requires the balanced use of monetary and fiscal policy in order to reach all of the nation's policy objectives.

[The prepared statement of Mr. Greenspan can be found in the appendix.]

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Chairman NEAL. Thank you very much for your very interesting testimony.

Mr. Chairman, let me start by asking you a couple of questions about our legislation to achieve zero inflation over the next 5 years. As we have held hearings on this proposal, and otherwise asked for comments from economists and others, it has seemed to me that broadly three objections have emerged as having some merit. I would like for you to comment briefly on each of them, if you would. If you see any others I would like to hear them, but so far it seems to me that these three emerge.

The first is that if we were to achieve zero inflation over the next 5 years, that would cause a recession. It seems clear to me that the policies needed to achieve zero inflation over that period of time would not cause a recession, but I would certainly like for you to comment on it. A second sort of problem with the idea that we have heard is that inflation and interest rates today poses no problem—somehow the economy and people have adjusted to them and it is all right to have inflation running at 5 percent, to have long-term treasury rates at 8 or 9 percent, to have credit card rates at 17 plus percent and business and consumer rates up over 10 percent. I don't think that is all right, but I would like for you to comment on that also. A third sort of objection to the idea has been that the Fed must stay entirely independent and that Congress should have no role in setting this overall policy goal, and that would have to include the administration also because, as you know, our legislation is legislation, would require a presidential signature.

Let me say those are the three main arguments we have heard the most of. There is, however, a fourth that I would like to you comment on also: that somehow there are other goals that are more important, that is to say that the Fed ought to attempt to control a particular foreign exchange rate for the dollar; or that the Fed ought to shoot for a particular level of short-term interest rates; or that it ought to shoot for a particular level of growth in the economy as opposed to zero inflation.

So I guess there are really four questions that I would like for you to comment on, if you would.

Mr. GREENSPAN. Well, Mr. Chairman, let me address them seriatim. We have, of course, given considerable thought to the question of endeavoring to bring inflation down to noninflationary levels, which we define as any particular price level which removes the uncertainties with respect to future inflation from economic decision-making.

It is our view that over a period of years we see no difficulty in bringing the inflation rate down from where it exists currently to a noninflationary level in the context of continued economic growth and the avoidance of a recession. Were the change needed to reach price stability required significantly greater, then I think the odds of our being able to do it without recession would be probably lower than any of us would find acceptable. But having brought the inflation rate down from double-digits to under 5 percent, the next stage, while difficult, is still achievable in our judgment without bringing on recession.

Chairman NEAL. Well, I specifically mentioned 5 years.

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Mr. GREENSPAN. I would say 5 years. As I have indicated to you privately and otherwise, I don't like to cite specific numbers with respect to each year or each particular period. I think there is sufficient complexity in the economy and the adjustment process that if we are short of the goal at any particular time, I don't think that is as critical as getting it right.

Chairman NEAL. Yes, sir, I quite agree with you.

Mr. GREENSPAN. The second question which presumes that the current inflation rate, the level of interest rates, and the current state of our financial markets is tolerable, is based on the assumption that the markets will stay where they are.

I have serious question that they can. In other words, it is plausible and in fact realistic to believe that, if you have a noninflationary environment—that is a steady state type of environment which has built into it a structure which can sustain it. One cannot say the same thing about an inflation rate which is approaching 5 percent, or somewhat under, but still close enough to that.

We are in an area where it is very easy to start inflation accelerating. I think the major reason we want to come down from this level is not that it is perceived to be doing great damage—although I think it is doing more damage than people realize—but that the risks of it accelerating from here are larger than I think we should be willing to tolerate. An acceleration in inflation when it takes hold is very difficult to restrain. The ultimate impact of accelerating inflation on employment, on the level of economic growth, and on the stability of the system is just too large, in my judgment, to be tolerable.

The third question is should Congress interfere in Federal Reserve policy. Well, Mr. Chairman, we would like as much flexibility as we can possibly have, but there is the Constitution of the United States which accords authority to the Congress, and that is Congress' judgment.

Our view basically is that we would like as much flexibility to attain our goals as possible, but this is an authority that comes to us from the Congress and the Constitution, and our judgment in this respect has to be tempered by the view of the Congress, and as a citizen, I think that is right and fully support it in that context.

Finally, as to the issue of whether other goals are more important, there is difficulty in knowing which particular goal affects which structure of the economy. We believe that holding the rate of inflation under control is far more important than any other variable largely because its effect is very significant. As I indicated in my earlier remarks, the maintenance of a noninflationary environment is a necessary condition and a major contributor toward maximum feasible economic growth and employment.

It also probably is the particular goal which would stabilize exchange rates because, as I have indicated in past testimony before this committee, one of the major goals of the G-7, for example, is to seek domestic price stability, rather, as the easiest, most effective way of achieving long-term exchange rate stability. So in that sense seeking price stability is also a means of seeking long-term exchange rate stability.

It is also the way of achieving the lowest nominal and real interest rates rather than to seek to achieve those directly. It is far su-

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perior to achieve low rates through a noninflationary environment so that while these other goals are clearly important, the interaction between those key goals and inflation, in my judgment, runs largely from inflation to those goals. Therefore it is far more effective to endeavor to control the degree of inflation and inflation expectations in an economy to achieve those goals than to endeavor to try to move directly to achieve them.

Chairman NEAL. Thank you, sir, very much.

Mr. Leach?

Mr. LEACH. Thank you, Mr. Chairman.

First, let me thank you for an extraordinarily fulsome report. Congress, by statute, gives you that responsibility. The report you have presented to us reflects very much a personal philosophy, as well as an institutional one. We in Congress ought to be appreciative of the fact that the Federal Reserve is one of the few institutions that takes its responsibilities seriously in complying with the whole spectrum of reports we legislate.

Having said that, let me ask a possibly unfair question: In achieving a balance between lower rates of inflation and higher growth, would it be more effective if Congress were to balance its budget or to pass a law calling for zero rates of inflation?

Mr. GREENSPAN. The first is superior to the latter.

Mr. LEACH. I am not as sympathetic as some to pejorative legislation. The real task we have to do is to work on the deficit. Central bankers have a tendency, and I think it is part of the confidence inspiring aspect of their jobs, to stress stability in price levels and stability in exchange rates, and point out the relationship between those two stabilities and economic growth.

The real ball game is rates of economic growth, not stability in exchange rates or stability in price levels. Here, your report is, I must say, extraordinarily optimistic. You, in effect have hinted that the new figures the Fed is receiving indicates the economy is picking up, particularly in the industrial sector. You have also suggested that in the long term you can effectively do your job, which is something that lots of other institutions in American society have a hard time suggesting.

The bottom line though is your suggestion that the rate of growth for the economy this year will be 1¾ to 2 percent. Is that an impressive goal for the Federal Reserve Board? If one turns around the sageness of stability arguments and suggests a rate of growth for the economy of, let's say, ¾ percent greater than that stated. Would you have a little different policy or do you think this is a policy that is most likely to achieve that objective as well?

Mr. GREENSPAN. Well, Congressman, let me just say that our goal is not 1¾ to 2 percent growth. That is the forecast of the members of the FOMC and the non-Member presidents as to what they perceive our overall policies are likely to achieve with respect to the economy as a whole.

Our basic policy, if you want to put it in those terms, essentially operates on the money supply, and it is quite conceivable that we can have an expansion of money supply, an improved inflation outlook, and a significantly higher real rate of growth than 1¾ to 2 percent.

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In other words, we are not seeking to make the growth rate 1¾ to 2. What we are seeking is to try to maintain a stable monetary environment, and it may well be that in that environment the forecast that the FOMC is making is too pessimistic.

I want to emphasize that it is not an integral part of our policy nor is it what we are endeavoring to seek. We don't vote on that forecast. We basically just report it.

Mr. LEACH. Well, I did note in your statement at several points, and I have never seen this from you before that the assessment of a majority of the Open Market Committee believes something.

Let me ask you what you believe. What do you think the rate of growth of the economy will be this year?

Mr. GREENSPAN. It is difficult to answer. Our main crucial goal at this particular point is to put behind us that significant weakening which created a degree of deterioration throughout the latter part of 1989 and to restore some stability. While I think it is premature to argue that that has been achieved, I think that the evidence of recent weeks is more encouraging than otherwise.

I don't find it very useful to put a specific number down on a forecast because I am not terribly certain what it means. I used to be in the forecasting business, and I was forced to do that and was always concerned about the degree of refinement that that forecast implied when the truth of the matter is, all that economists can do is get a sense of relationships and approximations, and if we can come out even reasonably close in that direction, I think that is as good as we can do.

I have no reason to believe that the number will be different from the average of the FOMC. I hope it will be higher. It may very well be higher, but that is not, as I emphasized before, a number we work with.

Mr. LEACH. I appreciate that very much, and I must say that I appreciate your optimism in referencing the higher side rather than the lower. I am reminded of Harold Shaprio, who is the President of Princeton and formerly headed an econometric modeling team at Michigan. He likes to say that they did a study once at Michigan on their forecasts and over about a 30-year period they had about 2 or 3 years in which they predicted a downturn in the economy.

And he said that prediction led the nightly news. Every time they predicted an up tick they got no attention. So it may not be news worthy that you are not predicting a downturn, but I appreciate that you are not.

Mr. Chairman, if I could ask one modest question on a little different subject, and this is more on the micromanagement side of financial regulation. As you know, the Fed has moved in a somewhat novel direction in authorizing several Canadian banks to operate in ways in this country that American commercial banks cannot, by allowing certain nontraditional activities to be conducted in a subsidiary of the bank, instead of in an affiliate of the bank.

Is that a trend that you suspect to continue? Does this decision set a precedent not only for other foreign banks but vis-a-vis U.S. banks? What is the Fed's view on this particular issue and what was——

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Mr. GREENSPAN. Mr. Leach, what we endeavor to do is to follow national treatment as closely as we can: that is, that there is a level playing field for all people in the business whether or not they are domestic or foreign.

On occasion the structure of foreign banking institutions is different from ours and it is often not easy to make the principle applicable. What we try to do in a number of regulations is to find as close an approximation as we can to the spirit of national treatment.

We have no endeavor to create precedents which create superior positions for foreign institutions relative to domestic. On the contrary, we work very hard to make certain, as best we can, that there are no differences of that nature.

Mr. LEACH. Well, I appreciate that perspective. I would only stress that there are kind of two different ways of looking at camparable treatment. The Europeans are saying comparable national treatment is for us to treat their banks the way they treat ours.

We say national treatment allows foreign banks in this country to operate the same way as American commercial banks do. The minute we lay down a precedent of giving a foreign entity different treatment than our own national banks, then we lay down a precedent which allows other foreign entities to suggest that they should to be treated in the same way. My own sense is that this decision sets a minor precedent that ought to be looked at with a great deal of caution.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you.

Mr. Chairman, in answering Mr. Leach's first question about the budget deficit, you didn't mean to imply, did you, that if we don't balance the budget we somehow ought not to strive to achieve zero inflation?

Mr. GREENSPAN. He merely asked me, gave me a choice, one or two.

Chairman NEAL. Which legislation would you pass, right.

Mr. GREENSPAN. I am sure you would choose one also.

Chairman NEAL. I must say I certainly would, although I don't think we have to make that choice. That is what I am trying to get at. You are not implying that there has to be.

Mr. GREENSPAN. No. In fact, I have been supportive of both one and two for a long time.

Chairman NEAL. Exactly. I would also point out that if we could achieve zero inflation and in fact if we would make it clear we were going to achieve zero inflation that that could have a very positive impact on balancing the budget because it would mean lower interest rates. Now that interest on the national debt is the third biggest item in the budget deficit, if we can lower the interest rate the Government pays on that we will reduce the budget deficit. So they work hand in glove.

Mr. Barnard?

Mr. BARNARD. Thank you, Mr. Chairman.

Welcome, Mr. Chairman, to the very, very fine report of what the Federal Reserve did accomplish 1989 and certainly your policies and goals for 1990.

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On page 4 of your statement you say that approaching price stability may involve a period of expansion. I need your speech writer for me sometimes. It says here, if you read it, approaching price stability may involve a period of expansion in activity at a rate below the growth in the economy's potential, thereby relieving pressures on resources.

You got me coming, and then you got me going on that particular statement.

Mr. GREENSPAN. We have many two-handed economists, even speech writers.

Mr. BARNARD. That is good to know, especially in this day and age. Does that mean that the inflation that we are experiencing at the very beginning of this year seems to be in keeping not with your policies, but in other words you are sympathetic with that rate of inflation increase that we experienced?

Mr. GREENSPAN. Well, the inflation rate so far this year has been horrendous. Last year or this year?

Mr. BARNARD. This year.

Mr. GREENSPAN. No, this year I would say as best we can judge, looking at the details of the price structure, the big surge in inflation which has occurred is essentially constrained to energy and food and has not spilled over into other parts of the economy. So while we are disturbed by this extraordinary surge, in our judgment it has not seemingly embedded itself either in higher wage or other costs.

Mr. BARNARD. So the Fed at this particular point does not see the need to try to rush to remedy monetary policy?

Mr. GREENSPAN. I know of no action we have taken which has responded to those individual price movements.

Mr. BARNARD. Mr. Chairman, does the Fed agree with the projections of economic growth and inflation that are currently in the administration's budget proposal. Do you think that they are optimistic?

Mr. GREENSPAN. Well, I think that you have to look at those forecasts in a different context. As I have said previously, administration forecasts presuppose the implementation of all of the President's recommendations, including a very significant reduction in the Federal budget deficit. And as I have said to other committees of the Congress, this particular set of forecasts, given the presumption that the Congress passes the President's budget in total, is not an unreasonable forecast.

Now, one can say that is an unrealistic expectation and may not happen, and surely in detail will not happen. But that is a different question. So in the sense of an internally consistent forecast, it is not one which I would have great quarrel with.

Obviously, we don't agree with that forecast, but the reason we don't agree with it is that we are not required in our view to assume what the administration does assume. Granted that, I think that they have done a job which is a reasonably sensible, balanced approach to the economic outlook.

Mr. BARNARD. If we rushed, and I use that word selectively, if we rushed to take Social Security off of budget, and which would immediately increase the deficit by 67 to $70 billion, how do you see that affecting growth?

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Mr. GREENSPAN. You mean growth?

Mr. BARNARD. Yes, economic growth.

Mr. GREENSPAN. I think the action of doing it as such is probably not something which would have any material effect unless and until the markets presumed that action on the actual deficit would occur as a consequence of that. If the markets perceive that a major reduction in long-term budget expenditures is underway by statute, I think we would find a remarkable response.

I think long-term interest rates would fall as inflation expectations would fall, and we would get very significant benefits from that occurring. But we have to distinguish between shuffling the various techniques we employ to measure the budget process and the real actions with respect to those things which affect savings and investment in the economy and Federal borrowing requirements.

Mr. BARNARD. but you expect interest rates in the long run to be reduced, but principally by expectations?

Mr. GREENSPAN. No. I would say the mere fact of moving the Social Security Trust Funds off budget and allowing, let's assume, Gramm-Rudman-Hollings to apply to the non-Social Security aspect of the budget would not in itself do anything unless the markets believed that the Congress was serious in meeting those goals.

I think that there is a degree of skepticism in the markets which can be addressed, in my judgment, only by action.

Mr. BARNARD. Mr. Chairman, as a regulator, are you concerned with the depressed condition of real estate in the Northeast and how it is affecting the banking system in that area?

Mr. GREENSPAN. Most certainly we are. In fact, we have monitored very closely the whole New England real estate environment, and have been looking at it in some considerable detail. We have been looking at the bank holding companies in New England also in some detail, and are trying to get as much information, judgment and sense of the markets as we conceivably can muster.

Mr. BARNARD. Mr. Chairman, my time has expired, but I would like to ask one other question, which I think is very significant to something you said. As I understand it, the Fed has out for comment the ability of bank holding companies to underwrite corporate equity.

Would you like to address, just indicated how the Fed feels about that?

Mr. GREENSPAN. Well, let me just tell you specifically what it is we are doing. A year ago when we granted so-called section 20 authorizations to underwrite corporate debt, we also indicated that we did not think at that time that the underwriting of corporate equity would be a appropriate and that, in a year, we would review that issue with the implication that if we thought it was the appropriate thing to do, we would go ahead, but only after Federal Reserve examiners reviewed the processes of those involved in corporate debt underwriting to make certain that their particular procedures and organizations were adequate to field equity as well.

Several days ago, the Federal Reserve Board authorized the Federal Reserve Bank of New York to begin to examine the individual banks who have made application to see whether in fact they have

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created a structure which in our judgment would match our requirements of safety and soundness in such underwriting activities. I presume that examination activity will begin within several weeks, and when the examinations are complete, it will come back to the Board, and the Board will make a judgment at that particular time as to whether or not individual applications should be moved forward or not.

Mr. BARNARD. That examination is examination of underwriting corporate debt?

Mr. GREENSPAN. It is to see how they have underwritten corporate debt and whether or not they will have the facilities and technical capabilities, in the judgment of the Board, to move forward into equities.

Mr. BARNARD. This year that has elapsed now, has there been any significant—have you noticed anything significant which you feel the Fed would change its policy on underwriting corporate debt? I mean, are you happy with the results of the permission?

Mr. GREENSPAN. That is one of the things we plan to be looking at. I know of nothing at this stage which suggests anything negative, and I did not sense anything from my colleagues on the Board to suggest that any of them had altered their basic view that it would be desirable to move forward, provided our criteria were met.

Mr. BARNARD. Mr. Chairman, just to satisfy some of the critics—of which I am certainly not one, I applause what the Fed is doing—but during this period of time you have periodically examined bank holding companies to determine the structure in which they are underwriting this corporate debt?

Mr. GREENSPAN. When reviews have been taking place, they are general reviews.

Mr. BARNARD. All of these underwritings done in separate subsidiaries?

Mr. GREENSPAN. That is correct. That is required.

Mr. BARNARD. Have I got time for one more question, Mr. Chairman?

Chairman NEAL. Yes.

Mr. BARNARD. Mr. Chairman, I was interested in the story which indicated that had Drexel Burnham Lambert not gone into bankruptcy, that there was a possibility that the Fed would come to their assistance. Did I read that wrong?

Mr. GREENSPAN. Well, I can't say that you read it wrong if somebody wrote it. I could merely indicate to you that there is serious question about the accuracy of such a statement.

Mr. BARNARD. Well, I was thinking so, too, but I notice it was given wide publicity that the Federal Reserve was contemplating coming to the aid of Drexel Burnham Lambert. I said now certainly they are not going to underwrite junk bonds now.

That was my last question. Thank you.

Mr. GREENSPAN. Let me just say, Mr. Barnard, that the basic concern of the Federal Reserve is not in individual institutions, but in the system, and our concern is always concentrated strictly on making certain that individual firm problems don't spill over into corrosive effects on the financial system, and——

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Mr. BARNARD. But they would not have had access to the discount window?

Mr. GREENSPAN. That is correct. They would not have.

Chairman NEAL. Mr. Chairman, I would like to ask you to expand your comments on the line of questioning that Mr. Leach pursued, because it seems to me that he has touched on a most important point concerning the conduct of monetary policy, and that is this question of the ideal policy. It is my understanding that achieving and maintaining zero inflation and price stability provides the ideal condition for maximum sustainable economic growth—that there is no other condition that will better assure that we can sustain economic growth at its maximum level and price stability. I would say the same thing about employment. Wouldn't you find that the majority of economists would agree with these ideas that I am expressing now, that that is the way to achieve maximum sustainable economic growth is to maintain price stability. That to maintain maximum sustainable employment, that the essential condition for that is zero inflation and price stability. I believe that you could say that about the maximum level of savings, and therefore, of investment and productivity growth. Don't we know enough now about the way our economy works to say with a high degree of certainty that we can maximize sustainable economic growth, employment, savings, investment, and so on, all the things that we are talking about, including exchange rate stability by achieving and maintaining zero inflation and price stability?

Mr. GREENSPAN. Well, Mr. Chairman, let me distinguish between a necessary condition and a sufficient condition. I would say—and I would certainly include myself in this—that a very substantial majority of economic analysts would argue that a noninflationary environment is a necessary condition for maximum sustainable economic growth and employment and a variety of other things. I would not—and I would think they would not—say it is sufficient, because it is very easy to envisage an economy with very significant amounts of Government controls, various different types of inefficiencies, extremely unstable fiscal policies and budgets, in which we would not achieve those goals.

Chairman NEAL. But we are talking about monetary policy.

Mr. GREENSPAN. If you are talking about monetary policy, the long-term optimum monetary policy which can contribute most to these various is to maintain a noninflationary environment.

Chairman NEAL. Thank you.

Mrs. Saiki.

Mrs. SAIKI. Thank you, Mr. Chairman.

I would like to add my appreciation for the soft landing, Mr. Chairman, of 1989, but looking forward as decisions have to be made up here on the Hill in the context of our concern for the rate of growth, I would like to ask you a question which may be a little unfair, but I would like your personal opinion as to whether a change in the treatment of capital gains promotes growth in our economy. Are we really going to make money as the Treasury suggests? I am sorry, would we make money for the Treasury as OMB suggests, or are we going to lose revenues as CBO suggests?

I would like to have your opinion on this.

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Mr. GREENSPAN. Well, I have always supported a cut in the capital gains tax rate because I don't think it is a productive tax for a market system of the type that we have. I think that a lower capital gains tax would basically over the long run be productive in that it would add to long-term economic growth.

I have also said that I, nonetheless, supported the 1986 tax reform compromise, which, as you know, eliminated the preference for capital gains as part of the package which brought the marginal tax rates down very substantially, and I still support that. In other words, if I am given the choice of a capital gains tax cut financed by higher marginal tax rates, I wouldn't think that would be a particularly good idea.

With respect to the issue of whether or not these are revenue gainers or revenue losers, the estimates are based on a very sensitive set of calculations which refer to the expected so-called unlocking of existing capital gains and the willingness on the part of individuals who have unrealized capital gains to, in fact, realize them if the tax rate falls. Obviously were they to do that, they would be paying taxes which they would not otherwise be paying, and that in a sense adds to tax revenues rather than losing them.

The sensitivity of those assumptions is very high, meaning very small changes in assumptions can create very significant changes in the revenue picture. I have seen estimates on both sides with very small differences in assumptions, and I am personally unable to make a choice as to what is an appropriate estimate, because I have not myself looked at or felt comfortable with the particular details that were presented. So I would just basically say I am generally supportive of the overall principle, hope we can implement it, but would not like to see it done in the context of unwinding what I thought was a very effective Tax Reform Act of 1986.

Mrs. SAIKI. Are you saying then, Mr. Chairman, that the gains that we may see with this kind of a plan that the administration has proposed will be a short term gain?

Mr. GREENSPAN. Well, not necessarily. I think that clearly most everybody has short, up-front realizable capital gains, and one would assume that one would get the maximum effect of unlocking at the earliest possible point. But I have not looked at the details of the calculation sufficiently to give you a good judgment as to whether those are statistically as good as they can be.

I have no reasons to believe that they are otherwise. In other words, they have good people over there making professional judgments, and I would have every reason to believe that those estimate are as good as you can get.

Mrs. SAIKI. Thank you.

Chairman NEAL. Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman.

Chairman Greenspan, I regret that I was unable to be here for the bulk of your testimony, bit I do note on page 7 that you allude to the fact that you anticipate less feverish activity, less feverish pace, with respect to merger and acquisitions, and I assume here you are alluding also perhaps—I am not sure, but perhaps—to the component of that activity that has been related to junk bonds, and evidently you have taken into account the most recent effects of

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the junk bond in the Drexel Burnham Lambert fall, et cetera, into your calculations.

Would you be willing to go any further in terms of giving a prognosis as to what the future—the effect of this activity, lessened activity is going to have on the future financial markets? Are we going to see more of abuse in terms of the consequences of the junk bond debacle here? Or don't you like the use of my word "debacle"?

Mr. GREENSPAN. I wouldn't choose to use it. I don't actually think there is a debacle here. I think what we are looking at is the satiation of the potential for significant restructuring on a profitable basis. I think a year or two ago, before this committee or the full committee, as I recall. I discussed the relationship between the rise in real interest rates that occurred in the early 1980s, the imbalances that that created with respect to the optimization of the various different parts of corporations, and argued that the process of trying to reestablish balance was the major reason why the very big surge in mergers, acquisitions, and restructurings occurred.

I think that what we have seen since is a very substantial degree of activity in trying to reestablish balance in a number of different firms, and that took as part of it a very large amount of conversion of equity to debt.

We have had an extraordinarily large amount of liquidation of equity financed by debt, in many respects financed by junk bonds. In fact, one can say where do junk bonds fit into the balance sheet, and to a very substantial extent, they have displaced equity. In that sense, I think I have argued that that is unfortunate, since the capital asset relationships in corporations have undergone a weakening.

Having said that, there is no question that there are valuable places for less than investment grade corporate bonds, and I think there have been a number of firms which have effectively used them to finance their balance sheet structure and probably have done better than they would have if junk bonds did not exist.

My impression basically is that we will work our way through this turmoil that we have seen in these markets and that it will eventually simmer down. We will find that rather than $200 billion outstanding, we will probably have somewhat less. But junk bonds will be an available part of the overall financing structure of American business, because I do think that they serve a useful purpose. I think their issuance may have gotten somewhat out of hand for a while, but I think over the long run they are a logical niche in the system, and I would expect that that is what is going to happen.

Mrs. ROUKEMA. So your prognosis is that after some initial turmoil the patient will stabilize, and not without too much problem with respect either to pensions or other kinds of investment instruments?

Mr. GREENSPAN. I don't think so. Obviously there are certain institutions that have a bit too much in the way of lower grade securities, but remember that those securities are still a relatively small part of the total investment scene. As a result of that, while there are a handful of institutions which have a disproportionately large amount of such instruments, that is not generally the case,

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and I would be most surprised if we had any secondary repercussions which could destabilize the total system.

Mrs. ROUKEMA. Well, good. I am happy to hear your assessment.

Thank you, Mr. Chairman.

Chairman NEAL. Mr. Chairman, on the question of junk bonds, isn't it true that there are only 1,300 or 1,400 companies in the whole United States that can issue bonds that are considered by the rating agencies to be investment grade bonds, and by definition, everything else is a junk bond? Do you remember that number?

Mr. GREENSPAN. I am not sure that that actually is a real number in the sense that it is a measure of the number of companies which have investment ratings. I am not sure that those who have not issued bonds are in that number, but that is, I believe, a published number, and I will submit that for the record.

[Chairman Greenspan subsequently furnished the following information for the record:]

At the end of September 1989, approximately 1,350 corporate issuers were rated as investment grade by Moody's Investors Service. This figure represents all issuing entities, including subsidiaries of parent corporations, having a rate of Baa or above. The number of entities actively issuing bonds may be considerably smaller.

Chairman NEAL. Anyway, the point I am trying to make, it is a relatively small number compared to the total number of companies in the United States.

Mr. GREENSPAN. Oh, yes, it is a relatively small number.

Chairman NEAL. It seems to me that those who want to refer to all these other bonds as junk bonds, would not have been pressed to refer to those other companies as junk companies. I don't think they are junk companies. Many of them are the growing companies attracting new investment, producing new products, employment, and it is just a shame to attach this pejorative to their debt issues.

They couldn't provide those jobs and so on without being able to attract some capital. It is certain the development of this market in less than investment grade debt is a positive one, it seems to me, not a negative one. Some of this debt has been used in a negative way, but certainly not most of it.

Mr. GREENSPAN. Mr. Chairman, I think it has been somewhat over-done, but the mere fact that it has been overdone does not undercut the fact that it does serve certain useful purposes.

Chairman NEAL. Well, vital purposes, it seems to me. It provides jobs for our people, competitiveness in the world economy.

I have been critical and I believe you have also, of efforts to use monetary policy to what a lot of people refer to as stabilization the foreign exchange value of the dollar. In other words, to have that as a primary objective of monetary policy, and as far as I know, that stabilizing exchange rate has not played any kind of distorting role in the recent conduct of monetary policy. And I raise this at this time because it does seem to me that soon we may face some real uncertainty and turbulence in exchange rates.

The recent proposal that West Germany and East Germany form a monetary union, it seems to me, will certainly introduce considerable uncertainty in the exchange rates of this new German mark vis-a-vis the dollar. Do you agree that we should not use monetary

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policy to stabilize this rate, but should rather let financial markets determine the value?

Mr. GREENSPAN. Well, Mr. Chairman, in our directives we list the various different factors which we consider in determining policy, and we do look at the exchange rate as an element which will affect the domestic economy and therefore subject to decisions with respect to policy. But in that particular context, how the Federal Open Market Committee will respond to various different scenarios that can emerge in the months ahead, as a consequence of the growing imminence of the merger of East and West Germany, is as yet too soon to make a judgment.

The reason I say that is that it is such a complex set of relationships that I wouldn't want to focus precisely on how policy will move in the event of significant changes abroad. All I can say to you is that the fundamental purpose of policy remains the stabilization of the domestic economy and the creation of a noninflationary environment. How we would specifically react to significant movements of an unstabilizing nature—should they occur and I must tell you I don't believe that they are in the realm of "what would you do if." There are a long series of contingencies that the Federal Reserve has outlined, and we even have several committees which look into various "what ifs." But they are really so complex that unless and until we are actually looking at a specific event, it is really very difficult to know what optimum policy at that point is, because it is likely to depend very concretely on the particular events of that time.

Chairman NEAL. Mr. Chairman, as you know, I have been very complimentary of what you and most of the other Board members are trying to do and I support your public statements in terms of achieving zero inflation, price stability, and so on, but now I want to ask you when can we expect a little more progress? If you will look at your own charts in the back of your testimony this morning—the top chart is the GNP price deflator, the bottom one is the consumer price index, and what that shows is that since 1984, except for the year 1986—which was a year in which the bottom really dropped out of oil prices—the average rate of inflation has been about what it is today. That is to say, it has been somewhere in that range of 4 to 5 percent. We both said many times that that is intolerably high level of inflation, and that maintaining a level of inflation at that rate does enormous damage to the economy.

It keeps interest rates much higher than they should be, than they could be. It lowers our possible growth rate. It lowers the rate of employment, makes us save less than we otherwise would, and so on. So I would just like to know when can we expect to see some progress in terms of reducing the rate of inflation?

Mr. GREENSPAN. Mr. Chairman, I have hesitated to make a specific forecast merely because the particular complexity of the economy at any particular point in time means that it will respond differently to various different types of monetary policies. Our general thrust is to keep pressure on, endeavor to gradually bring the rate down, but I have purposely avoided with you in earlier conversations citing a specific set of price goals independent of everything else.

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I think we do intend, and think it is crucially important, to bring the rate of inflation down to a noninflationary level for all the reasons we have discussed on numerous occasions, and I think that is the fundamental thrust of our long-term policy. We are biased in that direction, obviously, over the long run. But having said that, we want to be certain that we do not in the process inadvertently destabilize the economy, and as a consequence, I think that if we were to set specific goals of where we think prices should be at any time, we would probably find that we were not optimizing our policy over the long run.

So all I can say, Mr. Chairman, is that our view is that the direction of inflation has got to be down, but I don't think it is productive to set specific goals as to where we would like to see it at each point in time.

Chairman NEAL. Well, I know the difficulty with that, but I sure would encourage you to do all you reasonably can. Certainly I don't want to see us in any way destabilize the economy, certainly I do not want to see a recession. However, I think we ought to be able to achieve this goal of price stability without creating a recession.

A recession would create unnecessary pain, and would sap our will to achieve the goal. But, it seems to me that we can achieve more progress than we have, and that it would benefit all of our people, and I just hope that we can move in that direction more forcefully than we have.

Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman. I want to take a little different perspective, and let me just suggest, and I am hesitant as a representative of the minority to be partisan, but, Mr. Chairman, the last Democratic President served from 1977 to 1981.

The inflation rates were in the double digits. Here they are 4 percent during a time period in which Congress, which is the primary body in American society responsible for fiscal deficits, ran extraordinary deficits. One can agree or disagree with the Federal Reserve Board in all sorts of ways at various points in time. But in terms of maintaining 4 percent inflation, given the level of deficits from the fiscal side, is a mighty impressive performance, and I don't think anyone on this panel ought to be misled into thinking that a lot better job could have been done.

It is very impressive what the FED has done to curb inflation. I would like to turn, though, to the subject which I didn't know was going to be raised today and relate it back to the Drexel Burnham and junk bond issue. Frankly, Mr. Chairman, I think the term "junk" is too cheerful a term to apply to these bonds.

A junk bond implies something that maybe the buyer may not get a full rate of return. Well, these are more than "junk"; they are dung heap bonds. The reason I say that is that Congress knows better than any other institution that it isn't solely the saver that is losing money, although the savers are losing some. In the S&L collapse, it is Congress and the taxpayer that are is bailing out these bonds. That means they are not just junk; they are dung heaps.

Now, beyond that, Mr. Chairman, you have noted that junk bonds from time to time provide smaller businesses equity at a little lower rates than they would otherwise receive, and there are

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some cases that that is good for the economy, good for the smaller businesses.

On the other hand, the Chairman of the Federal Reserve Board has pointed out that disproportionately these bonds have been used to replace equity with debt and to the degree that they have been used to replace equity with debt, they are dung heaps for the economy as a whole.

Now, coming back to the Drexel issue which was raised, I was a little surprised, Mr. Chairman, that you didn't come down a little more firmly. The fact is the Federal Reserve Board does have extraordinary power and can in one way or another intervene and has a legal mandate to intervene to assist far more than the banking sector if it is in the interest of the economy.

Well, my view is the social case for saving rogue elephants is non-existent, and the economic case is also in this particular circumstance very weak as well. The failure of large institutions of any variety can be destabilizing, but it strikes me the failure of bad actors, especially ones which feast off over leveraging of the economy can be stabilizing rather than destabilizing. I would certainly hope that there is no hint that the Government is prepared to come in in an extraordinary way and prop up a particular financial institution whose social purpose, has ill-served the economy in the last decade and the replication of which will ill-serve it in the next.

I just want to raise the flag of concern against dung heap bonds and against the institutions that have propagated them on the American economy.

Mr. GREENSPAN. I think it is important to distinguish among the uses to which a significant number of the junk bonds or whatever you want to call them have been applied. Clearly, they have been to a very substantial extent displacing equity. For reasons which I discussed in my prepared remarks, I think the leveraging of corporate America is creating financial strains, a factor with which I personally feel uncomfortable and I have felt uncomfortable with it for quite a long period of time.

One can say that an evaluation of the junk bonds issued to date would come out decidedly mixed at best, but I think you have to distinguish between what they have been used for and what they can be used for, and my remarks with respect to them refers essentially to the latter because those types of instruments may be the best means by which certain small to medium-sized businesses can finance themselves. Consequently I think it is important not to throw all of that process under one classification.

There are actually large variety of differences among various different types of junk bonds. It seems like silliness, but there are high-grade junk bonds and low-grade junk bonds, and the markets will eventually make those particular distinctions.

With respect to Drexel, there was not at any time any desire on the part of those involved in the U.S. Government, relevant to this issue, who considered bailing out Drexel. I think that the issue of bailing out any institution is a very serious issue.

My judgment is we probably do it far more often than we should. I am certain that is the case, and I don't think that there was any inclination at all in this regard.

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Mr. LEACH. Well, I appreciate that very much, and I would only make one very minor distinction. There is a difference between high grade and low grade, but there is also a distinction between high purpose and low purpose.

You can have a higher grade junk bond, which is used to displace equity or capital with debt, and you can have a lower grade junk bond, which is not designed in that fashion.

Mr. GREENSPAN. I would agree with that.

Mr. LEACH. Coming back to the responsibility of Congress, one of the great questions given the overleveraging tribulations of the last decade is whether we want to change the mix of our tax policy. I don't know if you are prepared to comment on this, but one of the issues that many of us are concerned with is whether we ought perhaps, to lower the corporate rate in exchange for eliminating some aspects of tax deductibility of interest.

Does that strike you as a reasonable kind of tradeoff?

Mr. GREENSPAN. Well, I have always argued, Mr. Leach, that one of the problems we have in our system that inhibits savings, which I consider the most crucial short-fall our system now has, is the double taxation of dividends, and in fact the whole structure of corporate taxation. Any means that we can find to bring down the level of double taxation of dividends—and I don't want to comment specifically on mechanisms now because they are all very complex and require a good deal of thought—but I think that process, which is unfortunately expensive with respect to revenues, is something that we should nonetheless be looking carefully at.

If you are looking at a way of improving the structure of taxation in this country and in the broadest sense focusing on improving national savings, looking at that process and hopefully revamping it could be a very productive endeavor, in my judgment.

Mr. LEACH. Thank you.

Chairman NEAL. Mr. Barnard?

Mr. BARNARD. Mr. Chairman, on page 12 of your testimony you enumerated to some degree international financial markets and its effect on monetary policy, and then on page 12 you said that cross-border financial flows have accordingly accelerated at a pace in excess of global trade gains.

This globalization of financial markets has meant that events in one market or in one country can affect within minutes developments in markets throughout the world. I would direct a question having to do with the recent announcements that—example, with the German currency union of East Germany and West Germany. We are seeing various reports on the West German mark that it is getting exchange in narrow ranges from the East German mark.

I am not asking for your predictions, but do you feel that it will be somewhere between four to eight east marks for every one German mark?

Mr. GREENSPAN. Are you talking about the exchange rate between ost-marks and deutsche-marks?

Mr. BARNARD. Yes.

Mr. GREENSPAN. I can't answer that question because the choice that is involved is a very difficult one. The problem which they have is the extraordinary movement of people from East to West Germany. That is largely caused by the perceived differential in

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the standards of living between the two, and the choice of where you set that exchange rate creates a major problem because clearly from the West Germans' point of view, if the exchange rate is set in favor of the East German mark, that means the addition to the West German money supply then becomes larger.

But if the rate is set too low, meaning for the East German mark, it means that the real wage in West German marks is still very low and as a consequence we are very likely to get a continuation of the immigration flow, and I think both parties are most anxious to stabilize that.

Mr. BARNARD. But in spite of that effort, isn't it somewhat inescapable that we are going to see higher interest rates in Germany, either from borrowing or otherwise?

Mr. GREENSPAN. It is not clear to what the extent to which the current run up in rates has discounted perspective events or not. There is always an inclination to look at an economic development and then project interest rates as though there are not other participants in the market who have not already made that judgment and taken actions in the markets.

It is only when you can perceive an event which the rest of the market has not perceived that you are likely to be able to forecast where rates will or will not go, and it is just as conceivable at this stage that rates could go in the other direction because they may have been over-discounting what in fact the ultimate results may be.

So I don't think one can make that statement necessarily. There are tremendous degrees of uncertainty with respect to the process going on in Central Europe at this stage, and I think that we forecasters require a large element of humility when observing that phenomenon.

Mr. BARNARD. In discussing the aspects that are going on in Eastern Europe, you indicated in your remarks that even in the past we have seen tremendous reactions in other countries, and still we have been able to manage monetary policy without any problem, taking into effect those responsible.

That was on page 11. A former OMB Director, however, has said that he is concerned that the interest rates in Germany are going to be such that we could "lose the control of our monetary policy." Now, you don't have that fear?

Mr. GREENSPAN. No, I do not, Mr. Barnard.

Mr. BARNARD. My last question, Mr. Chairman, would be that in response to the vast changes in the globalization situation, are we moving fast enough in this country to address the banking laws that stand in between our institutions becoming—being able to serve the international financial marketplace?

Mr. GREENSPAN. I think not.

I think that we are lagging somewhat, and I think that if we could accelerate—move toward repeal of Glass-Steagall, for example—I think we would achieve a much improved financial structure which would enable us to compete increasingly effectively in the international arena.

Mr. BARNARD. We probably wouldn't be as subject to national treatment limitations as might develop in the future if we don't do that?

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Mr. GREENSPAN. I can't answer that, but I would say that basically this issue of Glass-Steagall should be fairly high up on the agenda for our considerations.

Mr. BARNARD. Thank you, sir.

Chairman NEAL. I am going to try to address a point Mr. Leach made without engaging in partisan wrangling. I hope I will be successful at that. I mean it in this way. One reason I take it up, frankly, is that it seems to me that it is important that on this subject of monetary policy that we have a clear historical understanding of how these things work. And Mr. Leach is absolutely correct that under a Democratic administration during the late 1970s the Federal Reserve ran a very high rate of inflation, and it was a mistake.

But the role of the President in that was in appointing the Chairman of the Federal Reserve System. He appointed the Chairman who guided that policy, and when it was recognized that that policy was incorrect, President Carter appointed Paul Volcker as Chairman of the Federal Reserve and gave him the specific mandate of lowering the rate of inflation, which he did.

Inflation is a monetary phenomenon, and it was caused by the Fed and it was then ground out of the system at least from its double digits to its current levels by the FED. And both of those Fed chairmen were named by President Carter, the one that created much of it and the one who solved much of the problem.

Now, on the question of the role of the Congress in setting and establishing budget deficits, it is important to set the historical record straight. The President, under our system, has enormous power in this regard. President Reagan was the most persuasive President, I guess, clearly since Roosevelt.

The Congress did grant him pretty much what he wanted, and these policies he wanted had a lot to do with the deficit. In fact he created much of the deficit that we have today—tripled the national debt in 8 years.

Now, it is true that that couldn't have happened unless Congress went along with it. I am trying not to be overly partisan, but to try to say that that was something that the Congress did and that the President had no impact on it just seems to me misses the point entirely.

I would like to yield to my friend if he disagrees with anything I have said.

Mr. LEACH. Well, I think that several of your comments are thoroughly valid. I would only suggest, though, that despite the exhortations of anyone from the outside, whether they be the President of the United States or a wife, the U.S. Congress has its own responsibilities to administer.

A President cannot spend a dime that we do not appropriate and cannot raise revenue that we do not authorize. The Congress of the United States has the primary responsibility for defining whether or not there is a fiscal deficit. Now, the gentleman in the chair is entirely correct in noting that we have had a very persuasive President.

He is entirely correct that under that Presidency the deficit rose dramatically. But I will be darned if I do not think that all of us should understand that it is our job to run the fiscal policy of the

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United States of America. If we fail we cannot simply blame a popular President. We must blame ourselves.

Chairman NEAL. Well, I have to agree with part of that, too. Let me pursue it one more minute. I voted against the Reagan budget. I said at the time I thought it would create a huge deficit. I underestimated by far the amount of the deficit, but I am a Member of this body.

What role do I play in it? What is my responsibility there? It was passed overwhelmingly. I think all Republicans voted for it, and there were enough Democrats to put the policy over the top. A majority of democrats voted against it. Well, where does the responsibility lie?

Mr. LEACH. Well, if the gentleman would yield, let me just stress that I consider the gentleman from North Carolina to be one of the most distinguished Members of this body, and one for whom I hold in high regard. I do not want to level any personal criticisms, but I think collectively all of us have to recognize that even though we are 1/435 of a particular body, we are accountable for the body itself. The Congress of the United States committed some egregious errors in the 1980's, and they can't be denied.

Chairman NEAL. I thank the gentleman.

Mr. Hoagland?

Mr. HOAGLAND. Well, thank you, Chairman Neal, for recognizing me.

Welcome, Chairman Greenspan, to the committee. It is a pleasure to see you this morning. You might recall, Chairman Greenspan, it was about a year ago when you gave some testimony before this committee that caused the stock market to go up 25 to 30 points, and I told you the story about how pleased my mother was.

Well, I just flew in from Omaha this morning, just got here about a half hour ago. And my mother reminded me last night that you would be testifying this morning and wanted me to give you an opportunity.

I know she will be pleased with the optimistic forecast that you have made here, but if you would like to elaborate on that in any respect, I know she would be pleased, and I would be pleased to hear that.

Mr. GREENSPAN. Well, all I can say to you, Mr. Hoagland, is I would like to convey to your mother my best wishes and felicitations, and I hope that when she comes to visit you I will get to meet her.

Mr. HOAGLAND. Well, she does follow you quite closely, Mr. Chairman, and she will appreciate that. And I appreciate it as well.

Mr. Chairman, on a different note, I think a number of us were somewhat alarmed at the testimony that we heard from the General Accounting Office and the Congressional Budget Office about 2½ weeks ago on the progress of the RTC. We were told then that as of, I think it was—I believe the date was January 15th, that only about 46 institutions had been closed, that those were by and large small institutions with assets in the $200 million to $250 million range, totaling only about $10 billion; that there were hundreds of sick institutions still out there, many of which had billions of dollars of assets.

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I wonder what you think needs to be done in order to speed up the process, if there is anything that we here in Congress should be doing, what recommendations you might have for your colleagues in the administrative branch.

Mr. GREENSPAN. We at the Oversight Board and the RTC Board are programming at this particular stage a significant acceleration of activity. If that fails to materialize to the satisfaction of the Congress, then I think that the Congress would want to take a much closer look and find a way in which that could be accelerated. However, at the moment, as I understand it, there is a significant increase in scheduled activity in that respect.

Mr. HOAGLAND. Have you had an opportunity to discuss with Mr. Kearney his reasons for leaving, Mr. Greenspan, and does that increase or decrease your concern about the way things are proceeding now?

Mr. GREENSPAN. I did speak to Mr. Kearney on it, and I think he repeated to me what he has said in public; namely, that his judgment as to what the particular role of the chief executive of the RTC Oversight Board was was different from the view of the Oversight Board, and I think that it was regrettable.

I think it was an honest misunderstanding. I don't think that communication was obviously as adequate as one could have made it. I was sorry to see him resign. I don't consider it a major set-back in the forward thrust of the organization. The work of the Oversight Board continues a pace and hopefully the transition will appear to be nothing more than a blip.

Mr. HOAGLAND. One criticism we are hearing here in Congress is that there are some different agencies involved in approving any given transaction, some overlapping lines of authority, and a general paralysis that is resulting from a fear of excessive criticism from the Banking Committee and other institutions should a large thrift be taken on and the resolution of that be imperfect in some respect or another?

Mr. GREENSPAN. I frankly don't know how valid the criticism is. We have a problem but we knew we had it right from the beginning—that the structure of the RTC and the Oversight Board is not the type of structure that one would set up for a private corporation.

You would not have two boards, in effect, but I think it was the Congress' judgment that even though there is a clear increase in complexity and a decline in managerial efficiency to put this type of complex structure in place, I think it was the judgment of the administration and the Congress that when you are dealing with huge amounts of taxpayer money that there has got to be some political oversight to the system, and that political oversight does create a slowdown.

It creates a more complex decision-making process than would exist in the private sector, but I think it is a very understandable tradeoff. I don't think it would be appropriate to put in the hands of an independent agency huge amount of taxpayer funds without the appropriate layering of political control on top of it.

We have to recognize that that political control has a cost, and the cost is some inefficiency, so it is a tradeoff that was made when

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FIRREA was first established. I think if you went back to square one you would probably have come out roughly the same.

It is up to us to make that system work, and I trust that the speculations in the press and elsewhere that everyone is afraid to move turns out to be inaccurate.

Mr. HOAGLAND. So you are satisfied that no structural changes need to be made at least at this point?

Mr. GREENSPAN. That's correct, Mr. Hoagland. For the moment I would say let's watch the way this evolves. If it fails to meet the Congress' expectations, then I think it should be reviewed, but I have no reason to believe at this stage that that will in fact be the case.

Mr. HOAGLAND. Are you also satisfied, Mr. Chairman, that men and women in the highest jobs in the administration are giving this problem the attention and the concern that it needs and deserves?

Mr. GREENSPAN. I don't know whether I can answer that very specifically. I will say this, that the various people within the Government—Secretary of the Treasury, the Deputy Secretary of the Treasury, the Under Secretary of Domestic Affairs, and the Federal Reserve Board at various different levels—are heavily committed to this process and, needless to say, the FDIC has taken on a very large operation.

Mr. HOAGLAND. Well, thank you, Mr. Chairman. Thank you.

Chairman NEAL. Mr. Leach?

Mr. LEACH. I want to thank our chairman for spending so much time with us. Thank you.

Chairman NEAL. Mr. Chairman, I have no further questions. I want to thank you also for coming this morning and keep up the good work. Just more of it.

The subcommittee stands adjourned subject to the call of the Chair.

[Whereupon, at 12:10 p.m., the hearing was adjourned, subject to the call of the Chair.]

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A P P E N D I X

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Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy
House Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

February 20, 1990

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Mr. Chairman and Members of the Committee, I appreciate the opportunity to testify today on the Federal Reserve's semiannual Monetary Policy Report to the Congress. My prepared remarks discuss our monetary policy actions and plans in the context not only of the current and projected state of the economy, but also against the background of our longer-term objectives and strategy for achieving them. The final section of the testimony addresses some issues for monetary policy raised by the increasingly international character of financial markets.

Economic and Monetary Policy Developments in 1989

Last year marked the seventh year of the longest peacetime expansion of the U.S. economy on record. Some 2-1/2 million jobs were created, and the civilian unemployment rate held steady at 5-1/4 percent. Inflation was held to a rate no faster than that in recent years, but unfortunately no progress was made in 1989 toward price stability. Thus, while we can look back with satisfaction at the economic progress made last year, there is still important work to be done.

About a year ago, Federal Reserve policy was in the final phase of a period of gradual tightening, designed to inhibit a buildup of inflation pressures. Interest rates moved higher through the winter, but started down when signs of more restrained aggregate demand and of reduced potential for higher inflation began to appear. As midyear approached, a marked strengthening of the dollar on foreign exchange markets further diminished the threat of accelerating inflation. New economic data suggested that the balance of risks had shifted toward the possibility of an undue weakening in economic activity. With M2 and M3

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below the lower bounds of their annual ranges in the spring, the Federal Reserve in June embarked on a series of measured easing steps that continued through late last year. Across the maturity spectrum, interest rates declined further, to levels about 1-1/2 percentage points below March peaks. Reductions in inflation expectations and reports of a softer economy evidently contributed to the drop in rates in longer-term markets.

The decrease in short-term rates lifted M2 to around the middle of its annual range in the latter part of the year. Efforts under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to close insolvent thrift institutions and strengthen undercapitalized thrifts led to a cutback of the industry's assets and funding needs. This behavior held down M3 growth in the second half of the year, and that aggregate ended the year around the lower end of its annual range. The restructuring of the thrift industry did not, however, seem to appreciably affect the overall cost and availability of residential mortgage credit, as other suppliers of this credit stepped into the breach. In the aggregate, the debt of nonfinancial sectors slowed somewhat, along with spending, to a rate just below the midpoint of its annual range.

So far this year, the federal funds rate has remained around 8-1/4 percent, but rates on Treasury securities and longer-term private instruments have reversed some of their earlier declines. Investors have reacted to stronger-than-expected economic data, a runup in energy

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prices, and increasingly attractive investment opportunities abroad, especially in Europe.

The Ultimate Objectives and Medium-Term Strategy of Monetary Policy

Monetary policy was conducted again last year with an eye on long-run policy goals, and economic developments in 1989 were consistent with the Federal Reserve's medium-term strategy for reaching them. The ultimate objective of economic policy is to foster the maximum sustainable rate of economic growth. This outcome depends on market mechanisms that provide incentives for economic progress by encouraging creativity, innovation, saving, and investment. Markets perform these tasks most effectively when individuals can reasonably believe that by forgoing consumption or leisure in the present they can reap adequate rewards in the future. Inflation insidiously undermines such confidence. It raises doubts in people's minds about the future real value of their nominal savings and earnings, and it distorts decision-making. Faced with inflation, investors are more likely to divert their attention to protecting the near-term purchasing power of their wealth. Modern-day examples of economies stunted by rapid inflation are instructive. In countries with high rates of inflation, people tend to put their savings in foreign currencies and commodities rather than in the financial investments and claims on productive assets that can best foster domestic growth. By ensuring stable prices, monetary policy can play its most important role in promoting economic progress.

The strategy of the Federal Open Market Committee (FOMC) for moving toward this goal remains the same--to restrain growth in money and

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aggregate demand in coming years enough to establish a clear downward tilt to the trend of inflation and inflation expectations, while avoiding a recession. Approaching price stability may involve a period of expansion in activity at a rate below the growth in the economy's potential, thereby relieving pressures on resources. Once some slack develops, real output growth can pick up to around its potential growth rate, even as inflation continues to trend down. Later, as price stability is approached, real output growth can move still higher, until full resource utilization is restored.

While these are the general principles, no one can be certain what path for the economy would, in practice, accompany the gradual approach to price stability. One key element that would minimize the costs associated with the transition would be a conviction of participants in the economy that the anti-inflation policy is credible, that is, likely to be effective and unlikely to be reversed.

Stability of the general price level will yield important long-run benefits. Nominal interest rates will be reduced with the disappearance of expectations of inflation, and real interest rates likely will be lower as well, as less uncertainty about the future behavior of overall prices induces a greater willingness to save. Higher saving and capital accumulation will enhance productivity, and the trend growth in real GNP will be greater than would be possible if the recent inflation rate continued.

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If past patterns of monetary behavior persist, maintaining price stability will require an average rate of M2 growth over time approximately equal to the trend growth in output. During the transition, the decline of market interest rates in response to the moderation in inflation would boost the public's demand for M2 relative to nominal spending, lowering M2 velocity. M2 growth over several years accordingly may show little deceleration, and it could actually speed up from time to time, as interest rates decline in fits and starts. Hence, the FOMC would not expect to lower its M2 range mechanically each and every year in the transition to price stability.

This qualitative description of our medium-term strategy is easy to state, but actually implementing it will be difficult. Unexpected developments no doubt will require flexible policy responses. Any such adjustments will not imply a retreat from the medium-term strategy or from ultimate policy goals. Rather, they will be mid-course corrections that attempt to keep the economy and prices on track. The easing of reserve pressures starting last June is a case in point. Successive FOMC decisions to ease operating policy were intended to forestall an economic downturn, the chances of which seemed to be increasing as the balance of risks shifted away from greater inflation. The FOMC was in no way abandoning its long-run goal of price stability. Instead, it sought financial conditions that would support the moderate economic expansion judged to be consistent with progress toward stable prices. In the event, output growth was sustained last year, although in the fourth quarter a major strike at Boeing combined with the first round of production cuts

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in the auto industry accentuated the underlying slowdown. On the inflation side, price increases in the second half were appreciably lower than those in the first. Although the CPI for January, to be announced tomorrow, probably will show a sizable jump in energy and food prices in the wake of December's cold snap, a reversal is apparently underway.

Monetary Policy and the Economic Outlook for 1990

Against this background, the Federal Reserve Governors and the Presidents of Reserve Banks foresee continued moderate economic expansion over 1990, consistent with conditions that will foster progress toward price stability over time. At its meeting earlier this month, the FOMC selected ranges for growth in money and debt it believes will promote this outcome.

My testimony last July indicated the very preliminary nature of the tentative ranges chosen for 1990, given the uncertain outlook for the economy, financial conditions, and appropriate growth of money and debt. With the economic situation not materially different from what was anticipated at that time, the FOMC reaffirmed the tentative 3 to 7 percent growth range for M2 in 1990 that it set last July. This range, which is the same as that used in 1989, is expected by most FOMC members to produce somewhat slower growth in nominal GNP this year. The declines in short-term interest rates through late last year can be expected to continue to boost the public's demands for liquid balances in M2, at least for a while longer. M2 growth over 1990 thus may be faster than in recent years, and M2 velocity could well decline over the four quarters

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of the year, absent a pronounced firming in short-term market interest rates.

In contrast with M2, the range for M3 has been reduced from its tentative range set last July. The new M3 range of 2-1/2 to 6-1/2 percent is intended to embody the same degree of restraint as the M2 range, but it was lowered to reflect the continued decline in thrift assets and funding needs now anticipated to accompany the ongoing restructuring of the thrift industry. This asset runoff began in earnest in the second half of last year, so its magnitude was not incorporated into the tentative M3 range for 1990 set last July. The bulk of the mortgage and real estate assets that thrifts will shed are expected to be acquired by the Resolution Trust Corporation and diversified investors other than depository institutions. Such assets thus will no longer be financed by monetary instruments included in M3. In addition, commercial banks are likely to be more cautious in their lending activities, reducing their need to issue wholesale managed liabilities included in M3. These influences should retard the growth of M3 relative to M2 again this year.

The debt of domestic nonfinancial sectors is expected to decelerate along with nominal GNP for a fourth straight year, and the Committee chose to lower the monitoring range for this aggregate to 5 to 9 percent for 1990. Merger and acquisition activity has retreated from the feverish pace of recent years, reflecting some well-publicized difficulties of restructured firms and more caution on the part of creditors. All other things equal, less restructuring activity and greater use of equity

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finance imply reduced corporate borrowing. An ebbing of growth in household debt also seems probable.

Over the last decade, money and debt aggregates have become less reliable guides for the Federal Reserve in conducting policy. The velocities of the aggregates have ranged widely from one quarter or one year to the next, in response to interest rate movements and special factors. In the coming year, the effects of the contraction of the thrift industry on the velocity of M3, and to a lesser extent on that of M2, are especially difficult to predict. While recognizing that the growth rates of the broader monetary aggregates over long periods are still good indicators of trends in inflation, the FOMC will continue to take an array of factors into account in guiding operating policy. Information about emerging patterns of inflationary pressure, business activity, and conditions in domestic and international financial markets again will need to supplement monetary data in providing the background for decisions about the appropriate operating stance.

The Committee's best judgment is that money and debt growth within these annual ranges will be compatible with a moderation in the expansion of nominal GNP. Most FOMC members and other Reserve Bank presidents foresee real GNP growing 1-3/4 to 2 percent over the year as a whole. Such a rate would be around last year's moderate pace, excluding the rebound in agricultural output from the 1988 drought. A slight easing of pressures on resources probably is in store. Inflation pressures should remain contained, even though the decline in the dollar's value over the past half-year likely will reverse some of the beneficial

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effects on domestic inflation stemming from the dollar's earlier appreciation. The CPI this year is projected to increase 4 to 4-1/2 percent, as compared with last year's 4-1/2 percent.

Risks to the Economic Outlook

Experience has shown such macroeconomic forecasts to be subject to a variety of risks. Assessing the balance of risks between production shortfalls and inflation pressures in the current outlook is complicated by several cross-currents in the domestic and international economic and financial situation.

One risk is that the weakness in economic activity evident around year-end may tend to cumulate, causing members' forecasts about production and employment this year to be overly optimistic. However, available indicators of near-term economic performance suggest that the weakest point may have passed. The inventory correction in the auto industry--a rapid one involving a sharp reduction in motor vehicle assemblies in January coupled with better motor vehicle sales--seems to be largely behind us. Industrial activity outside of motor vehicles appears to be holding up. Production of business equipment, where evidence has accumulated of some stability--if not an increase--in orders for capital goods, is likely to support manufacturing output in coming months. Housing starts were depressed in December by severely cold weather in much of the country. But starts bounced back strongly in January, in line with the large gain in construction employment last month. From these and similar data, one can infer the beginnings of a modest firming in economic activity. While we cannot be certain that we

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are as yet out of the recessionary woods, such evidence warrants at least guarded optimism.

There are, however, other undercurrents that continue to signal caution. One that could disturb the sustainability of the current economic expansion has been the recent substantial deterioration in profit margins. A continuation of this trend could seriously undercut the still expanding capital goods market. However, if current signs of an upturn in economic activity broaden, profit margins can be expected to stabilize.

A more deep-seated concern with respect to the longer-run viability of the expansion is the increase in debt leverage. Although the trends of income and cash flow may have turned the corner, the structure of the economy's financial balance sheet weighs increasingly heavily on the dynamics of economic expansion. In recent years, business debt burdens have been enlarged through corporate restructurings, and as a consequence interest costs as a percent of cash flow has risen markedly. Responding to certain well-publicized debt-servicing problems, creditors have become more selective in committing funds for these purposes. Within the banking industry, credit standards have been tightened for merger and LBO loans, as well as for some other business customers. Credit for construction projects reportedly has become less available because of FIRREA-imposed limits and heightened concerns about overbuilding in a number of real estate markets.

Among households, too, debt-servicing burdens have risen to historic highs relative to income, and delinquency rates have moved up of

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late. Suppliers of consumer and mortgage credit appear to have tightened lending terms a little. Real estate values have softened in some locales, although prices have maintained an uptrend in terms of the national averages, especially for single-family residences. These and other financial forces merit careful monitoring. While welcome from a supervisory perspective, more cautious lending does have the potential for damping aggregate demand.

It is difficult to assess how serious a threat increased leverage is to the current levels of economic activity. Clearly, should the economy fall into a recession, excess debt service costs would intensify the problems of adjustment. But it is unlikely that in current circumstances strains coming from the economy's financial balance sheet can themselves precipitate a downturn. As I indicated earlier, we expect nonfinancial debt growth to continue to slow from its frenetic pace of the mid-1980s. This should lessen the strain and hopefully the threat to the economy.

International Financial Markets and Monetary Policy

Among other concerns, recent events have highlighted the complex interactions between developments in the U.S. economy and financial markets and those in the other major industrial countries. Specifically, the parallel movements in long-term interest rates here and abroad over the early weeks of 1990 have raised questions: To what extent is the U.S. economy subject to influences from abroad? To what extent, as a consequence, have we lost control over our economic destiny? The simple answer to these questions is that the U.S. economy is influenced from

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abroad to a substantially greater degree than, say, two or three decades ago, but U.S. monetary policy is, nonetheless, able to carry out its responsibilities effectively.

The post-war period has seen markedly closer ties among the world's economies. Markets for goods have become increasingly, and irreversibly, integrated as a result of the downsizing of economic output and the consequent expansion of international trade. The past decade, in particular, also has witnessed the growing integration of financial markets around the world. Advancing technology has fostered the unbundling and transfer of risk and engendered a proliferation of new financial products. Cross border financial flows have accordingly accelerated at a pace in excess of global trade gains. This globalization of financial markets has meant that events in one market or in one country can affect within minutes developments in markets throughout the world.

More integrated and open financial markets have enabled all countries to reap the benefits of enhanced competition and improved allocation of capital. Our businesses can raise funds almost anywhere in the world. Our savers can choose from a lengthening menu of investments as they seek the highest possible return on their funds. Our financial institutions enjoy wider opportunities to compete.

In such an environment, a change in the expected rate of return on financial assets abroad naturally can affect the actions of borrowers or lenders in the United States. In response, exchange rates, asset prices, and rates of return all may adjust to new values.

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Strengthened linkages among world financial markets affect all markets and all investors. Just as U.S. markets are influenced by developments in markets abroad, foreign markets are influenced by events here. These channels of influence do not depend on whether a country is experiencing a deficit or a surplus in its current account. In today's financial markets, the net flows associated with current account surpluses and deficits are only the tip of the iceberg. What are more important are the huge stocks of financial claims--more than $1.5 trillion held in the United States by foreigners and more than $26 trillion of dollar-denominated claims on U.S. borrowers held by U.S. residents. This is in addition to the vast quantities of assets held in foreign currencies abroad. It is these holdings that can respond to changes in actual and expected rates of return.

In recent years we have seen several instances in which rates of return have changed essentially simultaneously around the world. For example, stock prices moved together in October 1987 and 1989, and in 1990 bond yields have risen markedly in many industrial countries.

However, we must be cautious in interpreting such events, and in drawing implications for the United States. Frequently, such movements occur in response to a common worldwide influence. Currently, the world economy is adjusting to the implications of changes in Eastern Europe, where there are tremendous new opportunities to invest and promote reconstruction and growth. Those opportunities, while contributing to the increase in interest rates in the United States, also open up new markets for our exports.

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Moreover, despite globalization, financial markets do not necessarily move together--they also respond to more localized influences. Over 1989, for example, bond yields in West Germany and Japan rose about a percentage point, while those in the United States fell by a similar amount. The contrast between 1989 and 1990 illustrates the complexity of relationships among financial markets. Interactions can show through in movements in exchange rates as well as interest rates, and changes in the relative prices of assets depend on a variety of factors, including economic developments and inflation expectations in various countries as well as monetary and fiscal policies here and abroad.

The importance of foreign economic policies for domestic economic conditions has given rise in recent years to a formalized process of policy coordination among the major industrial countries. The purpose of such coordination is to help policymakers achieve better performance in their national economies. It begins with improved communication among authorities about economic developments within each country. It includes systematic analysis of the likely impact of these developments on the economies of the partner countries and on variables such as exchange rates that are inherently jointly determined in international markets. Within such a framework, it is possible to consider alternative choices for economic policies and to account explicitly for the impacts of likely policy measures in one country on the other economies.

The influence of economic policies abroad and other foreign developments on the U.S. economy is profound, and the Federal Reserve must carefully take them into account when considering its monetary

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policy. But these influences do not fundamentally constrain our ability to meet our most important monetary policy objectives. Developments within U.S. financial markets remain the strongest influence on the asset prices and interest rates determined by those markets and, through them, on the U.S. economy. Exchange rates absorb much of the impact of developments in foreign asset markets, permitting U.S. interest rates to reflect primarily domestic economic conditions. Exchange rates influence the prices of products that do, or can, enter into international trade. Such factors can bring about changes in the composition of production between purely domestic goods and services and those entering international trade, and they can affect aggregate price movements for a time.

However, the overall pace of spending and output in the United States depends on the demands upon all sectors of the U.S. economy taken together. And our inflation rate, over time, depends on the strength of those demands relative to our ability to supply them out of domestic production. Because the Federal Reserve is able to affect short-term interest rates in U.S. financial markets, it is able to influence the pace of economic activity in the short-run and inflationary pressures longer-term. To be sure, monetary policy must currently balance more factors than in previous decades. But our goals are still achievable.

Monetary policy is only one tool, however, and it cannot be used successfully to meet multiple objectives. The Federal Reserve, for example, can address itself to either domestic prices or exchange rates but cannot be expected to achieve objectives for both simultaneously. Monetary policy alone is not readily capable of addressing today's large

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current account deficit, which is symptomatic of underlying imbalances among saving, spending, and production within the U.S. economy. Continued progress in reducing the federal deficit is a more appropriate instrument to raise domestic saving and free additional resources for productive investment. The long-term health of our economy requires the balanced use of monetary and fiscal policy in order to reach all of the nation's policy objectives.

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For use at 10:00 a.m., E.S.T.
Tuesday
February 20, 1990

Board of Governors of the Federal Reserve System

Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

February 20, 1990

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 20, 1990

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Alan Greenspan, *Chairman*

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Section 1: Monetary Policy and the Economic Outlook for 1990

The U.S. economy recorded its seventh consecutive year of expansion in 1989. Although growth was slower than in the preceding two years, it was sufficient to support the creation of 2½ million jobs and to hold the unemployment rate steady at 5¼ percent, the lowest reading since the early 1970s. On the external front, the trade and current account deficits shrank further in 1989. And while inflation remained undesirably high, the pace was less than many analysts – and, indeed, most members of the Federal Open Market Committee (FOMC) – had predicted, owing in part to the continuing diminution in longer-range inflation expectations.

In 1989, monetary policy was tailored to the changing contours of the economic expansion and the potential for inflation. Early in the year, as for most of 1988, the Federal Reserve tightened money market conditions in order to prevent pressures on wages and prices from building. Market rates of interest rose relative to those on deposit accounts, and unexpectedly large tax payments in April and May drained liquid balances, restraining the growth of the monetary aggregates in the first half of the year. By May, M2 and M3 lay below the lower bounds of the annual target ranges established by the FOMC.

Around midyear, risks of an acceleration in inflation were perceived to have diminished as pressures on industrial capacity had moderated, commodity prices had leveled out, and the dollar had strengthened on exchange markets, reinforcing the signals conveyed by the weakness in the monetary aggregates. In June, the FOMC began a series of steps, undertaken with care to avoid excessive inflationary stimulus, that trimmed 1½ percentage points from short-term interest rates by year-end. Longer-term interest rates moved down by a like amount, influenced by both the System's easing and a reduction in inflation expectations.

Growth of M2 rebounded to end the year at about the midpoint of the 1989 target range. Growth of M3, however, remained around the lower end of its range, as a contraction of the thrift industry, encouraged by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), reduced needs to tap M3 sources of funds. The primary effect of the shrinkage of the thrift industry's assets was a rechanneling of funds in mortgage markets, rather than a reduction in overall credit availability; growth of the nonfinancial sector debt aggregate monitored by the FOMC was just a bit slower in the second half than in the first, and this measure ended the year only a little below the midpoint of its range.

Thus far this year, the overnight rate on federal funds has held at 8¼ percent, but other market rates have risen. Increases of as much as ½ percentage point have been recorded at the longer end of the maturity spectrum. The bond markets responded to indicators suggesting a somewhat greater-than-anticipated buoyancy in economic activity – which may have both raised expected real returns on investment and renewed some apprehensions about the outlook for inflation. The rise in yields occurred in the context of a general runup in international capital market yields, which appears to have been in part a response to emerging opportunities associated with the opening of Eastern Europe; this development had particularly notable effects on the exchange value of the West German mark, which rose considerably relative to the dollar, the yen, and other non-EMS currencies.

Monetary Policy for 1990

The Federal Open Market Committee is committed to the achievement, over time, of price stability. The importance of this objective derives from the fact that the prospects for long-run growth in the economy are brightest when inflation need no longer be a material consideration in the decisions of households and firms. The members recognize that certain short-term factors – notably a sharp increase in food and energy prices – are likely to boost inflation early this year, but anticipate that these factors will not persist. Under these circumstances, policy can support further economic expansion without abandoning the goal of price stability.

To foster the achievement of those objectives, the Committee has selected a target range of 3 to 7 percent for M2 growth in 1990. Growth in M2 may be more rapid in 1990 than in recent years, and yet be consistent with some moderation in the rate of increase in nominal income and restraint on prices; in particular, M2 may grow more rapidly than nominal GNP in the first part of this year in lagged response to last year's interest rate movements. Eventually, however, slower M2 growth will be required to achieve and maintain price stability.

The Committee reduced the M3 range to 2½ to 6½ percent to take account of the effects of the restructuring of the thrift industry, which is expected to continue in 1990. A smaller proportion of mortgages is likely to be held at depository institutions and financed by

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Ranges of Growth for Monetary and Credit Aggregates

	1988	1989	1990
Percent change, fourth quarter to fourth quarter			
M2	4 to 8	3 to 7	3 to 7
M3	4 to 8	3½ to 7½	2½ to 6½
Debt	7 to 11	6½ to 10½	5 to 9

elements in M3; thrift institution assets should continue to decline, as some solvent thrifts will be under pressure to meet capital standards and insolvent thrifts will continue to be shrunk and closed, with a portion of their assets carried, temporarily, by the government. While some of the assets shed by thrifts are expected to be acquired by commercial banks, overall growth in the asset portfolios of banks is expected to be moderate, as these institutions exercise caution in extending credit. An increase in lender—and borrower—caution more generally points to some slowing in the pace at which nonfinancial sectors take on debt relative to their income in 1990. In particular, recent developments suggest that leveraged buyouts and other transactions that substitute debt for equity in corporate capital structures will be noticeably less important in 1990 than in recent years. Moreover, a further decline in the federal sector's deficit is expected to reduce credit growth this year. In light of these considerations, the Committee reduced the monitoring range for debt of the nonfinancial sectors to 5 to 9 percent.

The setting of targets for money growth in 1990 is made more difficult by uncertainty about developments affecting thrift institutions. The behavior of M3 and, to a more limited extent, M2 is likely to be affected by such developments, but there is only limited basis in experience to gauge the likely impact. In addition, in interpreting the growth of nonfinancial debt, the Committee will have to take into account the amount of Treasury borrowing (recorded as part of the debt aggregate) used to carry the assets of failed thrift institutions, pending their disposal. With these questions adding to the usual uncertainties about the relationship among movements in the aggregates and output and prices, the Committee agreed that, in implementing policy, they would need to continue to consider, in addition to the behavior of money, indicators of inflationary pressures and economic growth, as well as developments in financial and foreign exchange markets.

Economic Projections for 1990

The Committee members, and other Reserve Bank presidents, expect that growth in the real economy will be moderate during 1990. Most project real GNP growth over the four quarters of the year to be between 1¾ and 2 percent—essentially the same increase as in 1989, excluding the bounceback in farm output after the 1988 drought. It is expected that this pace of expansion will be reflected in some easing of pressures on domestic resources; the central tendency of forecasts is for an unemployment rate of 5½ to 5¾ percent in the fourth quarter.

Certain factors have caused an uptick in inflation early this year. Most notably, prices for food and energy increased sharply as the year began, reflecting the impact of the unusually cold weather in December. However, these run-ups should be largely reversed in coming months, and inflation in food and energy prices for the year as a whole may not differ much from increases in other prices.

Given their importance in determining the trend of overall costs, a deceleration in the cost of labor inputs is an integral part of any solid progress toward price stability. Nominal wages and total compensation have grown relatively rapidly during the past two years, while increases in labor productivity have diminished. With prices being constrained by domestic and international competition, especially in goods markets, profit margins have been squeezed to low levels. A restoration of more normal margins ultimately will be necessary if businesses are to have the wherewithal and incentive to maintain and improve the stock of plant and equipment.

Unfortunately, the near-term prospects for a moderation in labor cost pressures are not favorable. Com-

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Economic Projections for 1990

	1989 Actual	FOMC Members and Other FRB Presidents		Administration
		Range	Central Tendency	
Percent change, fourth quarter to fourth quarter				
Nominal GNP	6.4	4 to 7	5½ to 6½	7.0
Real GNP	2.4	1 to 2¼	1¾ to 2	2.6
Consumer price index	4.5	3½ to 5	4 to 4½	4.1[1]
Average level in the fourth quarter, percent				
Unemployment rate	5.3	5½ to 6½	5½ to 5¾	5.4[2]

1. CPI-W. FOMC forecasts are for CPI-U.
2. Percent of total labor force, including armed forces residing in the United States.

pensation growth is being boosted in the first half of 1990 by an increase in social security taxes and a hike in the minimum wage. The anticipated easing of pressures in the labor market should help produce some moderation in the pace of wage increases in the second half of 1990, but the Committee will continue to monitor closely the growth of labor costs for signs of progress in this area.

Finally, the recent depreciation of the dollar likely will constitute another impetus to near-term price increases, reversing the restraining influence exerted by a strong dollar through most of last year. Prices of imported goods, excluding oil, increased in the fourth quarter after declining through the first three quarters of 1989. The full effect of this upturn likely will not be felt on the domestic price level until some additional time has passed.

Despite these adverse elements in the near-term picture, the Committee believes that progress toward price stability can be achieved over time, given the apparently moderate pace of activity. In terms of the consumer price index, most members expect an increase of between 4 and 4½ percent, compared with the 4.5 percent advance recorded in 1989.

Relative to the Committee, the Administration currently is forecasting more rapid growth in real and nominal GNP. At the same time, the Administration's projection for consumer price inflation is at the low end of the Committee's central tendency range. In its *Annual Report*, the Council of Economic Advisers argues that, if nominal GNP were to grow at a 7 percent annual rate this year—as the Council is projecting—then M2 could exceed its target range, particularly if interest rates fall as projected in the Administration forecast. As suggested above, monetary relationships cannot be predicted with absolute precision, but the Council's assessment is reasonable. And, although most Committee members believe that growth in nominal GNP more likely will be between 5½ and 6½ percent, a more rapid expansion in nominal income would be welcome if it promised to be accompanied by a declining path for inflation in 1990 and beyond.

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Section 2: The Performance of the Economy in 1989

Real GNP grew 2½ percent over the four quarters of 1989, 2 percent after adjustment for the recovery in farm output from the drought losses of the prior year. This constituted a significant downshifting in the pace of expansion from the unsustainably rapid rates of 1987 and 1988, which had carried activity to the point that inflationary strains were beginning to become visible in the economy. As the year progressed, clear signs emerged that pressures on resource utilization were easing, particularly in the industrial sector. Nonetheless, the overall unemployment rate remained at 5.3 percent, the lowest reading since 1973, and inflation remained at 4½ percent despite the restraining influence of a dollar that was strong for most of the year.

The deceleration in business activity last year reflected, to some degree, the monetary tightening from early 1988 through early 1989 that was undertaken with a view toward damping the inflation forces. Partly as a consequence of that tightening, the U.S. dollar appreciated in the foreign exchange markets from early 1988 through mid-1989, contributing to a slackening of foreign demand for U.S. products. At the same time, domestic demand also slowed, more for goods than for services. Reflecting these developments, the slowdown in activity was concentrated in the manufacturing sector: Factory employment, which increased a total of 90,000 over the first three months of 1989, declined 195,000 over the remainder of the year, and growth in manufacturing production slowed from 5½ percent in 1988 to only 1¾ percent last year. Employment in manufacturing fell further in January of this year, but that decline was largely attributable to temporary layoffs in the automobile industry and most of the affected workers have since been recalled.

As noted above, the rate of inflation was about the same in 1989 as it had been in the preceding two years. While the appreciation of the U.S. dollar through the first half of the year helped to hold down the prices of imported goods, the high level of resource utilization continued to exert pressure on wages and prices. In that regard, the moderation in the expansion of real activity during 1989 was a necessary development in establishing an economic environment more conducive to progress over time toward price stability.

The Household Sector

Household spending softened significantly in 1989, with a marked weakening in the demand for motor vehicles and housing. Real consumer spending on goods and services increased 2¼ percent over the four quarters of 1989, 1½ percentage points less than in 1988. Growth in real disposable income slowed last year, but continued to outstrip growth in spending, and, as a result, the personal saving rate increased to 5¾ percent in the fourth quarter of 1989.

The slackening in consumer demand was concentrated in spending on goods. Real spending on durable goods was about unchanged from the fourth quarter of 1988 to the fourth quarter of 1989—after jumping 8 percent in the prior year—chiefly reflecting a slump in purchases of motor vehicles. Spending on nondurable goods also decelerated, increasing only ½ percent in 1989 after a 2 percent advance in 1988. The principal support to consumer spending came from continued large gains in outlays for services. Spending on medical care moved up 7½ percent in real terms last year, and now constitutes 11 percent of total consumption expenditures—up from 8 percent in 1970. Outlays for other services rose 3¼ percent, with sizable increases in a number of categories.

Sales of cars and light trucks fell ¾ million units in 1989, to 14½ million. Most of the decline reflected reduced sales of cars produced by U.S.-owned automakers; a decline in sales of imported automobiles was about offset by an increase in sales of foreign nameplates produced in U.S. plants. The slowing in motor vehicle sales was most pronounced during the fourth quarter of 1989, reflecting a "payback" for sales that had been advanced into the third quarter and a relatively large increase in sticker prices on 1990-model cars. Although part of this increase reflected the inclusion of additional equipment—notably the addition of passive restraint systems to many models—consumers nevertheless reacted adversely to the overall increase in prices. Beyond these influences, longer-run factors appear to have been damping demand for autos and light trucks during 1989; in particular, the robust pace of sales earlier in the expansion seems to have satisfied demand pent up during the recessionary period of the early 1980s. The rebuilding of the motor vehicle stock suggests that future sales are likely to depend more heavily on replacement needs.

Residential investment fell in real terms through the first three quarters of 1989, and with only a slight upturn in the fourth quarter, expenditures decreased 6 percent on net over the year. Construction was weighed down throughout 1989 by the overbuilding that occurred in some locales earlier in the decade. Vacancy rates were especially high for multifamily

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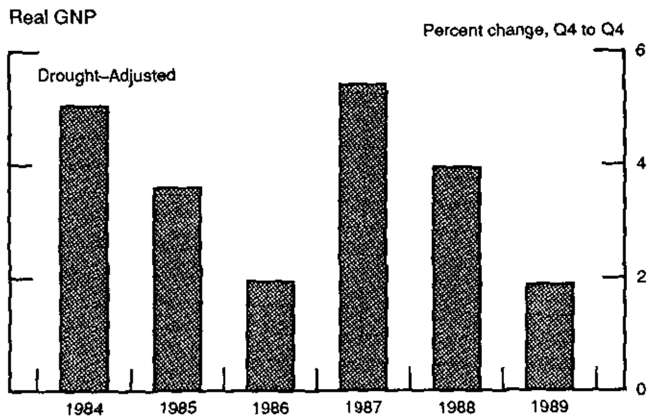

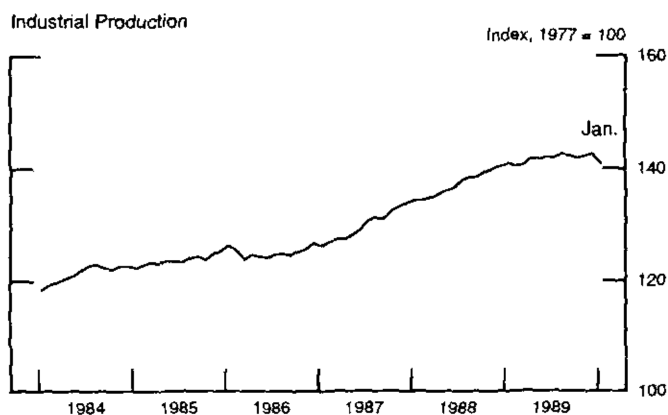

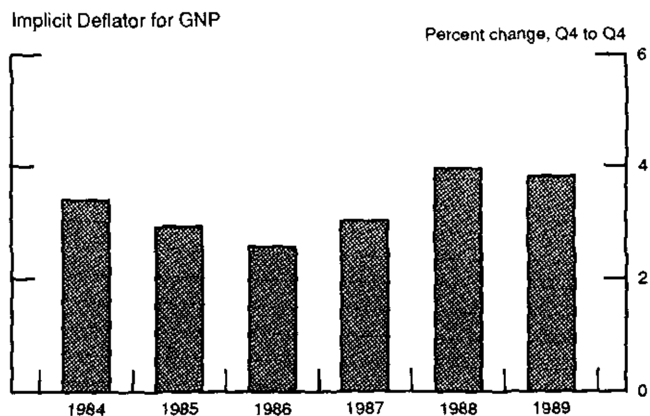

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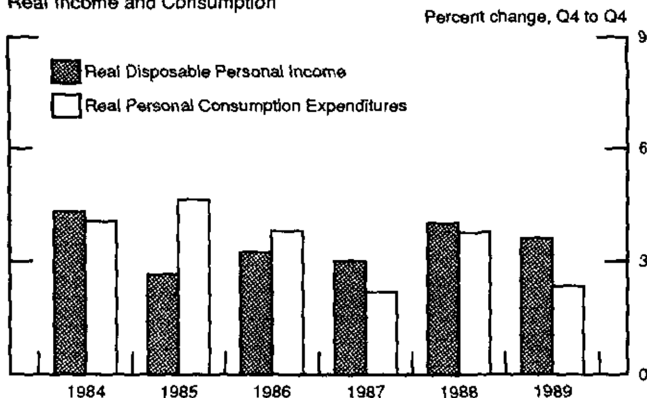

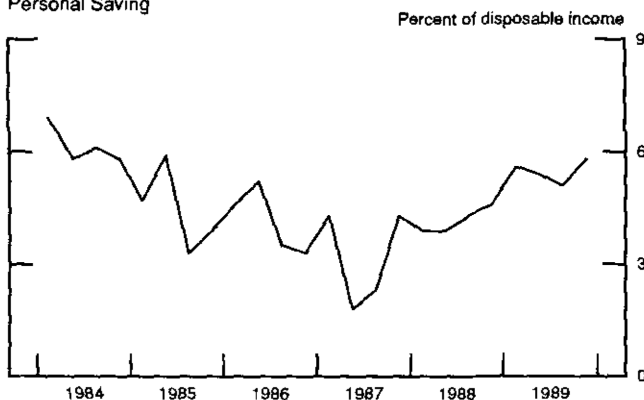

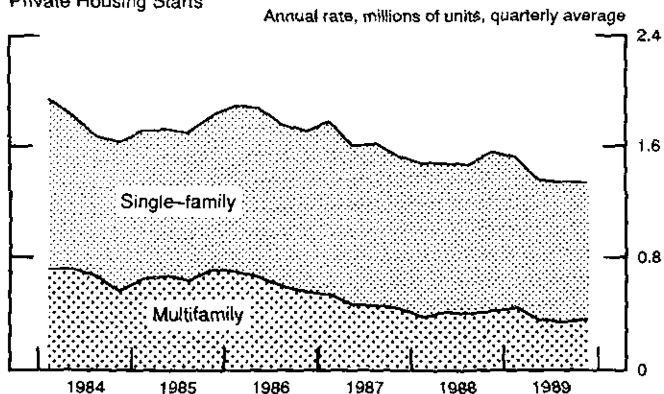

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rental and condominium units. In the single-family sector, affordability problems constrained demand, dramatically so in those areas in which home prices had soared relative to household income.

Mortgage interest rates declined more than a percentage point, on net, between the spring of 1989 and the end of the year, helping to arrest the contraction in housing activity; however, the response to the easing in rates appears to have been muted somewhat by a reduction in the availability of construction credit, likely reflecting, in part, the tightening of regulatory standards in the thrift industry and the closing of a number of insolvent institutions. Exceptionally cold weather also hampered building late in the year, but a sharp December drop in housing starts was followed by a record jump in activity last month.

The Business Sector

Business fixed investment, adjusted for inflation, increased only 1 percent at an annual rate during the second half of 1989 after surging 7¾ percent during the first half. Although competitive pressures forced many firms to continue seeking efficiency gains through capital investment, the deceleration in overall economic growth made the need for capacity expansion less urgent, and shrinking profits reduced the availability of internal finance.

Spending on equipment moved up briskly during the first half of 1989, with particularly notable gains in outlays for information processing equipment—computers, photocopiers, telecommunications devices, and the like. However, equipment outlays were flat in the second half of the year: growth in the information processing category slowed sharply, and spending in most other categories was either flat or down. Purchases of motor vehicles dropped sharply in the fourth quarter from the elevated levels of the second and third quarters. There were a few exceptions to the general pattern of weakness during the second half. Spending on aircraft was greater in the second half of 1989 than in the first half, and would have increased still more had it not been for the strike at Boeing. Outlays for tractors and agricultural machinery moved up smartly; spending on farm equipment has been buoyed by the substantial improvements over the past several years in the financial health of the agricultural sector. Over the four quarters of 1989, total spending on equipment increased 6 percent in real terms—about 1 percentage point below the robust pace of 1988.

Business spending for new construction edged down ½ percent in real terms during 1989—the second consecutive yearly decline. Commercial construction, which includes office buildings, was especially weak; vacancy rates for office space remain at high levels in many areas, lowering prospective returns on new investment. Outlays for drilling and mining, which had dropped 20 percent over the four quarters of 1988, moved down further in the first quarter of 1989; later in the year, drilling activity revived as crude oil prices firmed. The industrial sector was the most notable exception to the overall pattern of weakness: Real outlays increased 11 percent in 1989, largely owing to construction that had been planned in 1987 and 1988 when capacity in many basic industries tightened substantially and profitability was improving sharply.

As noted above, the slowdown in investment spending during the second half of last year likely was exacerbated by the deterioration in corporate cash flow. Before-tax operating profits of nonfinancial corporations dropped 12 percent from the fourth quarter of 1988 to the third quarter of 1989 (latest data available); after-tax profits were off in about the same proportion. Reflecting the increased pressures from labor and materials costs—and a highly competitive domestic and international environment—pre-tax domestic profits of nonfinancial corporations as a share of gross domestic product declined to an average level of 8 percent during the first three quarters of 1989, the lowest reading since 1982. At the same time, taxes as a share of pre-tax operating profits increased to an estimated 44 percent in the first three quarters of 1989; since 1985, this figure has retraced a bit more than half of its decline from 54 percent in 1980.

Nonfarm business inventory investment averaged $21 billion in 1989. Although the average pace of accumulation last year was slower than in 1988, the pattern across sectors was somewhat uneven. Some of the buildup in stocks took place in industries—such as aircraft—where orders and shipments have been strong for some time now. But inventories in some other sectors became uncomfortably heavy at times and precipitated adjustments in orders and production. The clearest area of inventory imbalance at the end of the year was at auto dealers, where stocks of domestically produced automobiles were at 1.7 million units in December—almost three months' supply at the sluggish fourth-quarter sales pace. In response, the domestic automakers implemented a new round of sales incentives and cut sharply the planned assembly rate for the first quarter of 1990. Elsewhere in the retail sector, inventories moved up substantially relative to sales at general merchandise outlets. Overall, however, most sectors of the economy have adjusted fairly promptly to the deceleration in sales, and

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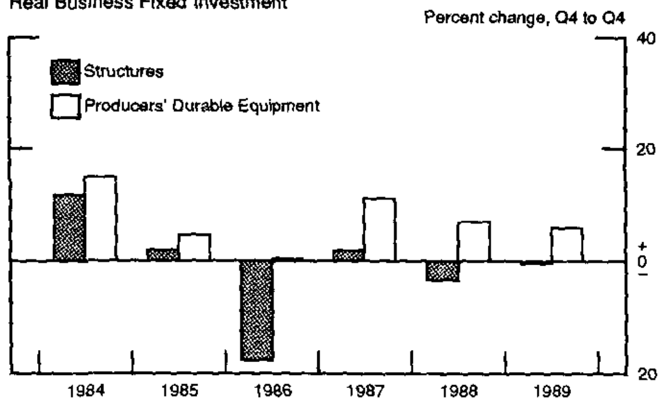

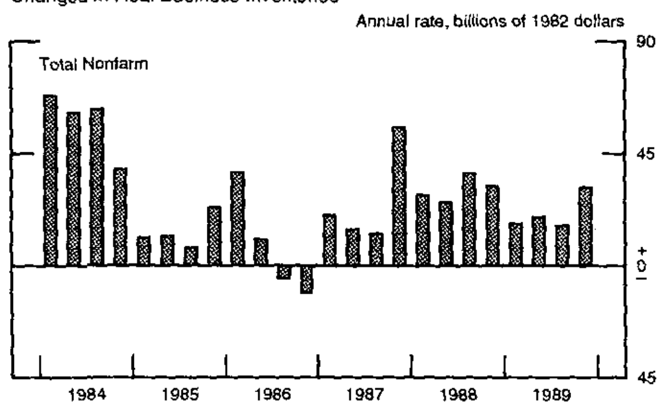

* Ratio of profits from domestic operations with inventory valuation and capital consumption adjustments to gross domestic product of nonfinancial corporate sector.

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appear to have succeeded in preventing serious overhangs from developing.

The Government Sector

Budgetary pressures continued to restrain the growth of purchases at all levels of government. At the federal level, purchases fell 3 percent in real terms over the four quarters of 1989, lower defense purchases accounting for the bulk of the decline. Nondefense purchases also declined in real terms from the fourth quarter of 1988 to the fourth quarter of 1989; increases in such areas as the space program and drug interdiction were more than offset by general budgetary restraint that imposed real declines on most other discretionary programs.

In terms of the unified budget, the federal deficit in fiscal year 1989 was $152 billion, slightly smaller than in 1988. Growth in total federal outlays, which includes transfer payments and interest costs as well as purchases of goods and services, picked up a bit in fiscal year 1989. Outlays were boosted at the end of the fiscal year by the initial $9 billion of spending by the Resolution Trust Corporation. On the revenue side of the ledger, growth in federal receipts also increased in fiscal 1989. The acceleration occurred in the individual income tax category, but strong increases also were recorded in corporate and social security tax payments.

Purchases of goods and services at the state and local level increased 2½ percent in real terms over the four quarters of 1989, down more than a percentage point from the average pace of the preceding five years. Nonetheless, there were some areas of growth. Spending for educational buildings increased, and employment in the state and local sector rose 350,000 over the year, largely driven by a pickup in hiring by schools. Despite the overall slowdown in the growth of purchases, the budgetary position of the state and local sector deteriorated further over the year; the annualized deficit of operating and capital accounts, which excludes social insurance funds, increased $6 billion over the first three quarters of 1989 and appears to have worsened further in the fourth quarter.

The External Sector

The U.S. external deficits improved somewhat in 1989, but not by as much as in 1988. On a balance-of-payments basis, the deficit on merchandise trade fell from an annual rate of $128 billion in the fourth quarter of 1988 (and $127 billion for the year as a whole) to $114 billion in the first quarter of 1989. Thereafter, there was no further net improvement. The appreciation in the foreign exchange value of the dollar between early 1988 and mid-1989 appears to have played an important role in inhibiting further progress on the trade front. During the first three quarters of 1989, the current account, excluding the influence of capital gains and losses that are largely caused by currency fluctuations, showed a deficit of $106 billion at an annual rate – somewhat below the $124 billion deficit in the comparable period of 1988.

Measured in terms of the other Group of Ten currencies, the foreign exchange value of the U.S. dollar in December 1989 was about 3 percent above its level in December 1988, but the dollar has moved lower thus far in 1990. In real terms, the net appreciation of the dollar during 1989 in terms of the other G-10 currencies was about 5 percent, as consumer prices rose somewhat faster here than abroad, on average. Over the year, the dollar moved lower on balance against the currencies of South Korea, Singapore, and especially Taiwan. From a longer perspective, the modest uptrend on balance in the dollar over the past two years marked a sharp departure from the substantial weakening seen during the 1985-1987 period.

The behavior of the dollar differed greatly between the two halves of 1989. In the first half, the dollar appreciated 12 percent in terms of the other G-10 currencies, while depreciating against the currencies of South Korea and Taiwan. The dollar fluctuated during the summer, and later in the year unwound most of the prior appreciation, as U.S. interest rates eased relative to rates abroad and in response to concerted intervention in exchange markets in the weeks immediately after the September meeting of Group of Seven officials and to events in Eastern Europe. In the second half of the year, the dollar rose against the currencies of South Korea and Taiwan while depreciating in terms of the Singapore dollar. Over the course of 1989, the dollar appreciated nearly 16 percent against the Japanese yen and 14 percent against the British pound, but it depreciated slightly against the German mark, the Canadian dollar, and most other major currencies.

On a GNP basis, merchandise exports increased about 11 percent in real terms over the four quarters of 1989 – roughly 4 percentage points less than in 1988. This deceleration took place despite continued strong growth in economic activity in most foreign industrial countries (with the exception of Canada and the United Kingdom), and appears to have reflected, in large part, the effect on U.S. competitiveness of the dollar's appreciation and more rapid U.S. inflation over 1988 and much of 1989. Exports were also depressed in the fourth quarter of 1989 by a number of special factors including the Boeing strike. The volume of agricultural exports increased about 11 percent in 1989 – a bit faster

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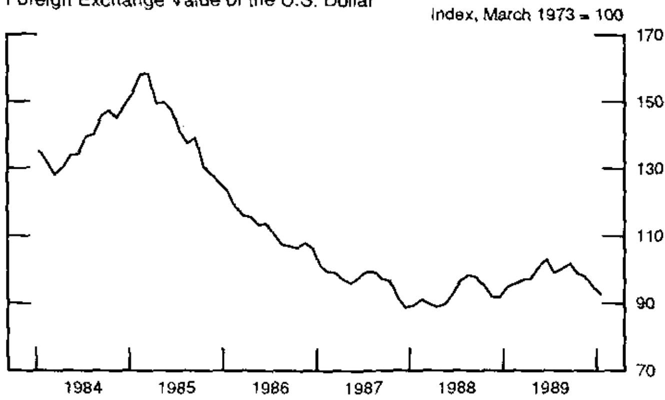

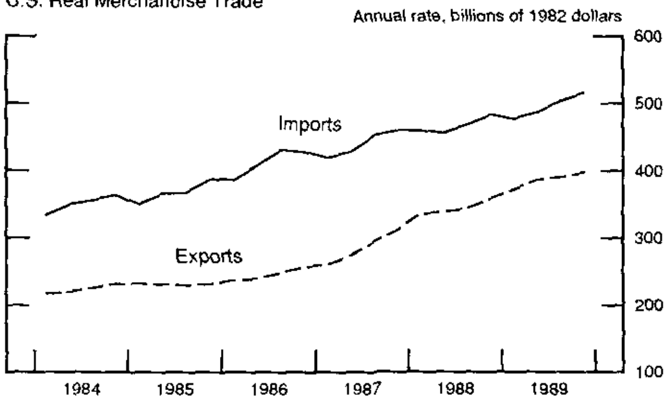

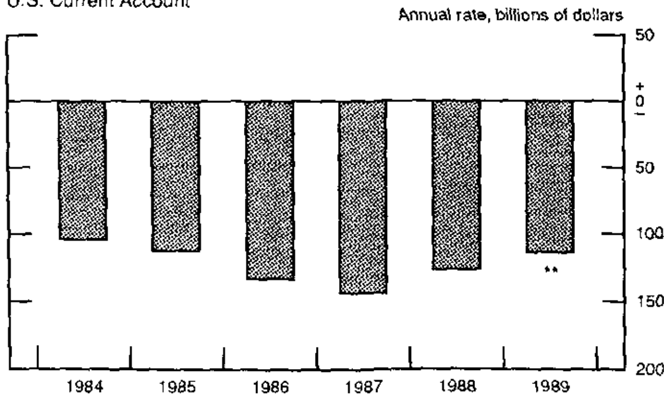

* Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of the other G–10 countries. Weights are 1972–76 global trade of each of the 10 countries.

** Average of first three quarters of 1989, at an annual rate.

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even than the robust pace of 1988. The value of agricultural exports rose much less, however, as agricultural export prices reversed the drought-induced increases of the previous year.

Merchandise imports excluding oil expanded about 7 percent in real terms during 1989, with much of the rise accounted for by imports of computers. Imports of oil increased 6 percent from the fourth quarter of 1988 to the fourth quarter of 1989, to a rate of 8.3 million barrels per day. At the same time, the average price per barrel increased almost 40 percent, and the nation's bill for foreign oil jumped 45 percent.

The counterpart of the current account deficit of $106 billion at an annual rate over the first three quarters of 1989 was a recorded net capital inflow of about $60 billion at an annual rate and an unusually large statistical discrepancy, especially in the second quarter. More than half of the recorded net inflow of capital reflected transactions in securities, as foreign private holdings of U.S. securities rose nearly $50 billion (half of the increase being in holdings of U.S. Treasury securities), while U.S. holdings of foreign securities increased a bit less than $20 billion. Net direct investment accounted for another substantial portion of the inflow; foreign direct investment holdings in the U.S. rose more than $40 billion, and U.S. holdings abroad rose only half as much. Over the first three quarters of 1989, foreign official assets in the United States increased almost $15 billion, but this increase was more than offset by the increase in U.S. official holdings of assets abroad, largely associated with U.S. intervention operations to resist the dollar's strength.

Labor Markets

Employment growth slowed in the second half of 1989; nonetheless, nonfarm payrolls increased nearly 2½ million during the year. The bulk of this expansion occurred in the service-producing sector. By contrast, the manufacturing sector shed 100,000 jobs. These job losses were more than accounted for by declines in the durable goods industries, and appeared to reflect the slump in auto sales, the weakening in capital spending, and the effects of a stronger dollar on exports and imports.

Despite the slowdown in new job creation, the overall balance of supply and demand in the labor market remained steady over the year. The civilian unemployment rate, which had declined about ½ percentage point over the twelve months of 1988, finished 1989 at 5.3 percent—unchanged from twelve months earlier. Moreover, there was no increase in the number of "discouraged" workers—those who say they would re-enter the labor force if they thought they could find a job. Nor was there any net increase in workers who accepted part-time employment when they would have preferred full-time. The proportion of the civilian population with jobs reached an historic high.

Reflecting the tightness of labor markets and the persistence of inflation expectations in the 4 to 5 percent range, according to surveys, the employment cost index for wages and salaries in nonfarm private industry increased 4¼ percent over the 12 months of 1989—about the same as in 1988. Benefit costs continued to rise more rapidly than wages and salaries last year, with health insurance costs remaining a major factor; nonetheless, the rate of growth in overall benefit costs slowed in 1989, in part because of a smaller increase in social security taxes than in 1988. Total compensation—including both wages and salaries and benefits—rose 4¾ percent during 1989. Compensation growth in the service-producing sector—at 5 percent—continued to outpace the gain in the goods-producing sector by about ¾ percentage point.

A slowdown in the growth of productivity often accompanies a softening in the general economy, and productivity gains were lackluster in 1989. Output per hour in the private nonfarm business sector increased only ½ percent over the four quarters of the year—1 percentage point below the rate of increase in 1988. In the manufacturing sector, productivity gains during the first half of 1989 kept pace with the 1988 average of 3 percent; in the second half, however, productivity growth slowed to an annual rate of 2¼ percent. Reflecting both the persistent growth in hourly compensation and the disappointing developments in productivity, unit labor costs in private nonfarm industry rose 5 percent over the four quarters of 1989—the largest increase since 1982.

Price Developments

Inflation in consumer prices remained in the neighborhood of 4½ percent for the third year in a row, as the level of economic activity was strong and continued to exert pressures on available resources. During the first half of the year, overall inflation was boosted by a sharp runup in energy prices and a carry-over from 1988 of drought-related increases in food prices. However, inflation in food prices slowed during the second half, and energy prices retraced about a third of the earlier run-up. Prices for imported goods excluding oil were little changed over 1989, on net, and acted as a moderating influence on consumer price inflation.

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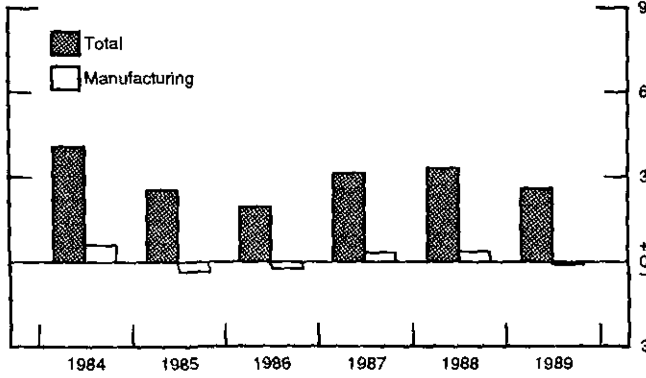

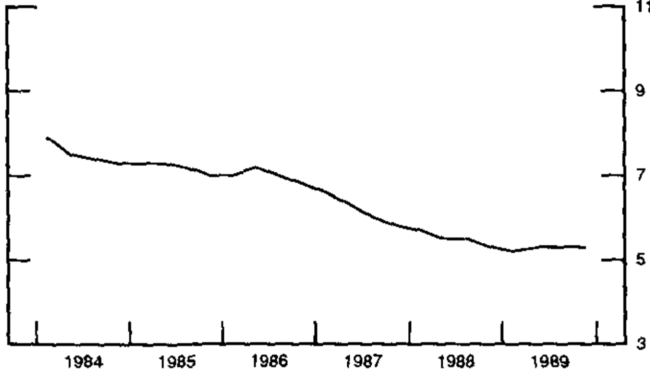

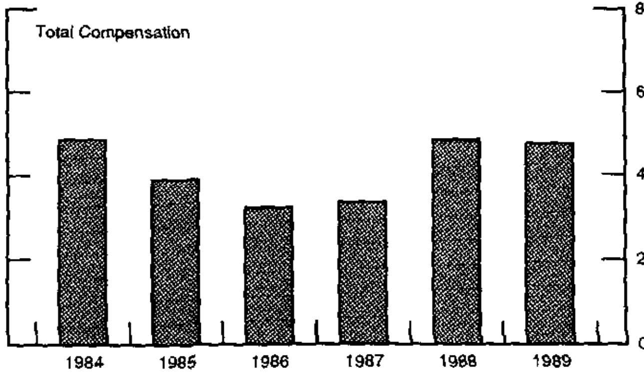

* Employment Cost Index for private industry, excluding farm and household workers.

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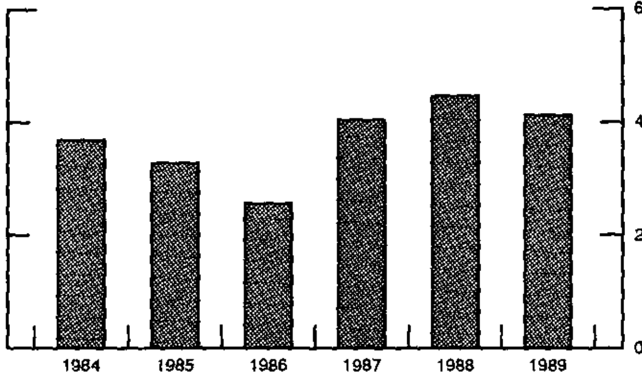

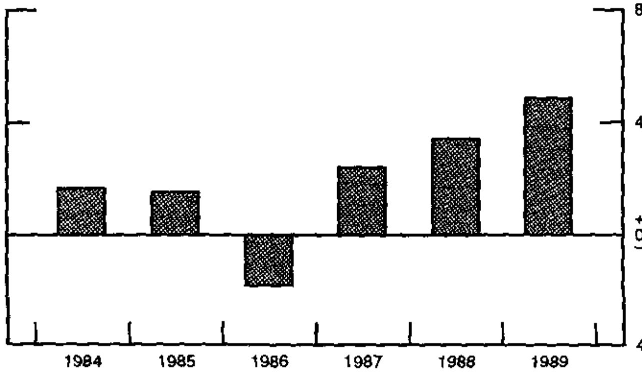

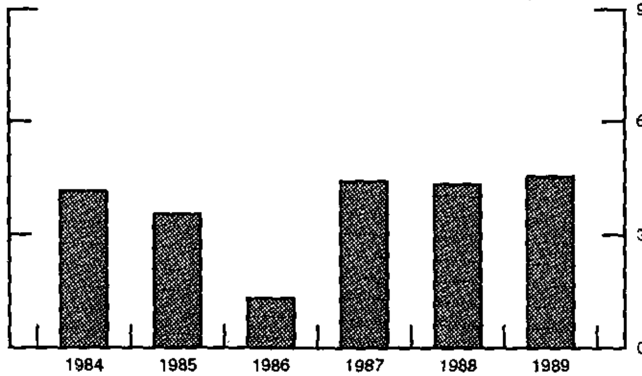

* Consumer Price Index for all urban consumers.

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Food prices increased 5½ percent at the retail level, slightly more than in 1988 when a number of crops were severely damaged by drought. Continued supply problems in some agricultural markets in 1989—notably a poor wheat crop and a shortfall in dairy production—likely prevented a deceleration from the drought-induced rate of increase in 1988. At the same time, increases in demand, including sharp increases in exports of some commodities, also appear to have played a role. Still another impetus to inflation in the food area last year evidently came from the continuing rise in processing and marketing costs.

Consumer energy prices surged 17 percent at an annual rate during the first six months of 1989, before dropping back 6 percent in the second half. During the first half of the year, retail energy prices were driven up by increases in the cost of crude oil. The increase in gasoline prices at mid-year was exaggerated by the introduction of tighter standards governing the composition of gasoline during summer months. Gasoline prices eased considerably in the second half, reflecting a dip in crude oil prices and the expiration of the summer-time standards. Taking the twelve months of 1989 as a whole, the increase in retail energy prices came to a bit more than 5 percent. Heating oil prices jumped sharply at the turn of the year, reflecting a surge in demand caused by December's unusually cold weather. The spike in heating fuel prices largely reversed itself in spot markets during January of this year, but crude oil prices remained at high levels.

Consumer price increases for items other than food and energy remained at about 4½ percent in 1989. Developments in this category likely would have been less favorable had the dollar not been appreciating in foreign exchange markets through the first half of 1989. The prices of consumer commodities excluding food and energy decelerated sharply, and this slowdown was particularly marked for some categories where import penetration is high, including apparel and recreational equipment. Given the dollar's more recent depreciation, however, the moderating effect of import prices on overall inflation may be diminishing. Indeed, prices for imported goods excluding oil turned up in the fourth quarter of 1989, after declining earlier in the year. In contrast to goods prices, the prices of nonenergy services—which make up half of the overall consumer price index—increased 5¼ percent in 1989, ¼ percentage point more than in 1988. The pickup in this category was led by rents, medical services, and entertainment services.

At the producer level, prices of finished goods increased 7½ percent at an annual rate during the first half—almost twice the pace of 1988—before slowing to a 2½ percent annual rate of increase over the second half. In large part, developments in this sector reflected the same sharp swings in energy prices that affected consumer prices. At earlier stages of processing, the index for intermediate materials excluding food and energy decelerated sharply during the first half of the year, and then edged down in the second half. For the year as a whole, this index registered a net increase of only 1 percent, compared with more than 7 percent in 1988. The sharp deceleration in this category appears to have reflected a relaxation of earlier pressures on capacity in the primary processing industries, and the influence of the rising dollar through the first half of last year. Also consistent with the weakening in the manufacturing sector and the strength of the dollar, the index for crude nonfood materials excluding energy declined 3¾ percent over the year, and spot prices for industrial metals moved sharply lower during the year, owing in part to large declines for steel scrap, copper, and aluminum.

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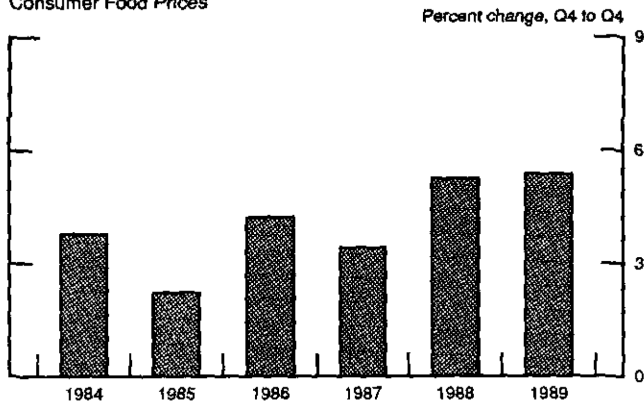

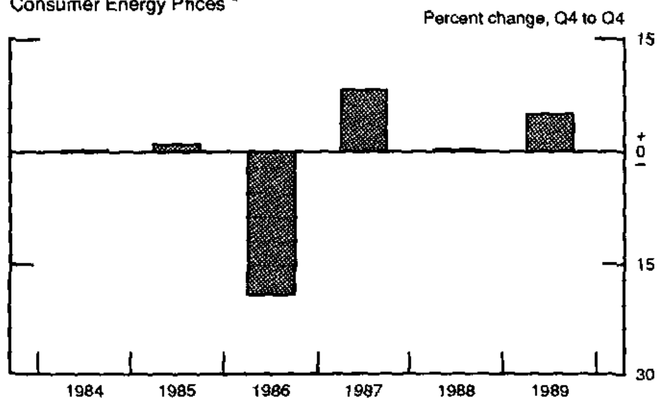

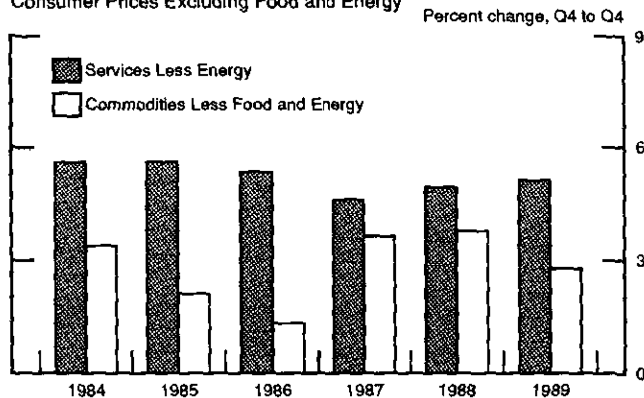

* Consumer Price Index for all urban consumers.

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Section 3: Monetary and Financial Developments During 1989

In 1989, the Federal Reserve continued to pursue a policy aimed at containing and ultimately eliminating inflation while providing support for continued economic expansion. In implementing that policy, the Federal Open Market Committee maintained a flexible approach to monetary targeting, with policy responding to emerging conditions in the economy and financial markets, as well as to the growth of the monetary aggregates relative to their established target ranges. This flexibility has been necessitated by the substantial variability in the short-run relationship between the monetary aggregates and economic performance; however, when viewed over a longer perspective, those aggregates are still useful in conveying information about price developments.

As the year began, monetary policy was following through on a set of measured steps begun a year earlier to check inflationary pressures. By then, however, evidence of a slackening in aggregate demand, along with sluggish growth of the monetary aggregates, suggested that the year-long rise in short-term interest rates was noticeably restraining the potential for more inflation. But, after a ½ percentage point increase in the discount rate at the end of February, the Federal Reserve took no further policy action until June. Over the balance of 1989, the Federal Reserve moved toward an easing of money market conditions, as indications mounted of slack in demand and lessened inflation pressures. The easing in reserve availability induced declines in short-term interest rates of 1½ percentage points; money growth strengthened appreciably, and M2 was near the middle of its target range by the end of 1989. The level of M3, on the other hand, remained around the lower bound of its range, with its weakness mostly reflecting the shifting pattern of financial intermediation as the thrift industry retrenched. The growth of nonfinancial debt was trimmed to 8 percent in 1989, about in line with the slowing in the growth of nominal GNP, and ended the year at the midpoint of its monitoring range.

Implementation of Monetary Policy

In the opening months of the year, the Federal Open Market Committee extended the move toward restraint that had begun almost a year earlier, seeking to counter a disquieting intensification of inflationary pressures. Policy actions in January and February, restraining reserve availability and raising the discount rate, prompted a further ¾ percentage point increase in short-term market interest rates. Longer-term rates, however, moved up only moderately; the tightening apparently had been widely anticipated and was viewed as helping to avoid an escalation in underlying inflation. Real short-term interest rates—nominal rates adjusted for expected price inflation—likely moved higher, though remaining below peak levels earlier in the expansion; these gains contributed to a strengthening of the foreign exchange value of the dollar over this period, while the growth of the monetary aggregates slowed as the additional policy restraint reinforced the effects of actions in 1988.

As evidence on prospective trends in inflation and spending became more mixed in the second quarter, the Committee refrained from further tightening and in June began to ease pressures on reserve markets. As the information on the real economy, along with the continued rise in the dollar, suggested that the outlook for inflation was improving, most long-term nominal interest rates fell as much as a percentage point from their March peaks; the yield on the bellwether thirty-year Treasury bond moved down to about 8 percent by the end of June. The decline in interest rates outstripped the reduction in most measures of investors' inflation expectations, so that estimated real interest rates fell from their levels of earlier in the year. These declines in nominal and real interest rates, however, were not accompanied by declines in the foreign exchange value of the dollar. Rather, because of better-than-expected trade reports and political turmoil abroad, the dollar strengthened further.

In July, when the FOMC met for its semiannual review of the growth ranges for money and credit, M2 and M3 lay at or a bit below the lower bounds of their target cones. This weakness, reinforcing the signals from prices and activity, contributed to the Committee's decision to take additional easing action in reserve markets. The Committee reaffirmed the existing annual target ranges for the monetary and debt aggregates and tentatively retained those ranges for the next year, since they were likely to encompass money growth that would foster further economic expansion and moderation of price pressures in 1990.

Late in the summer, longer-term interest rates turned higher, as several economic data releases suggested reinvigorated inflationary pressures. With growth in the monetary aggregates rebounding, the Committee kept reserve conditions about unchanged until the direction of the economy and prices clarified.

Beginning in October, amid indications of added risks of a weakening in the economic expansion, the

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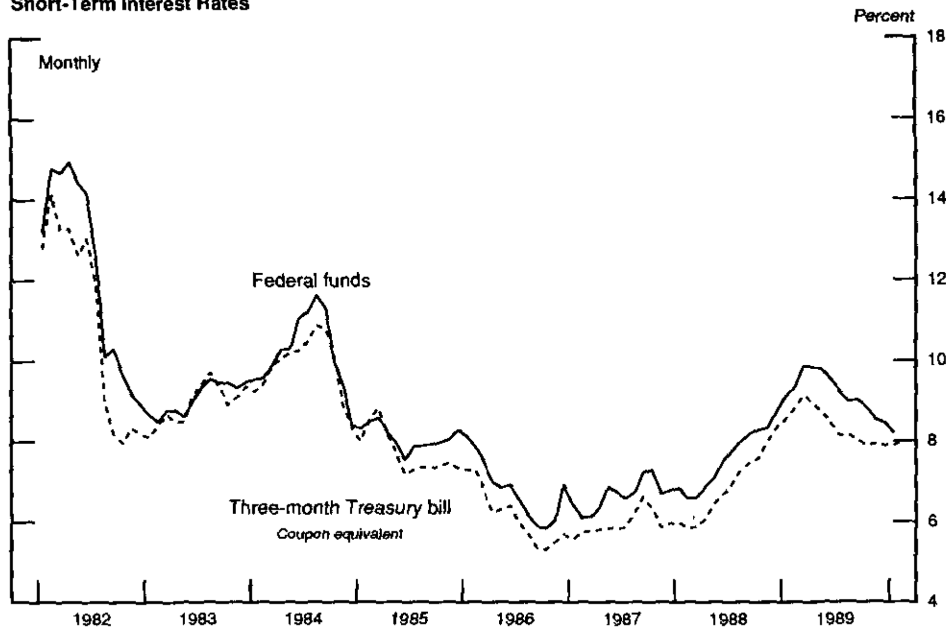

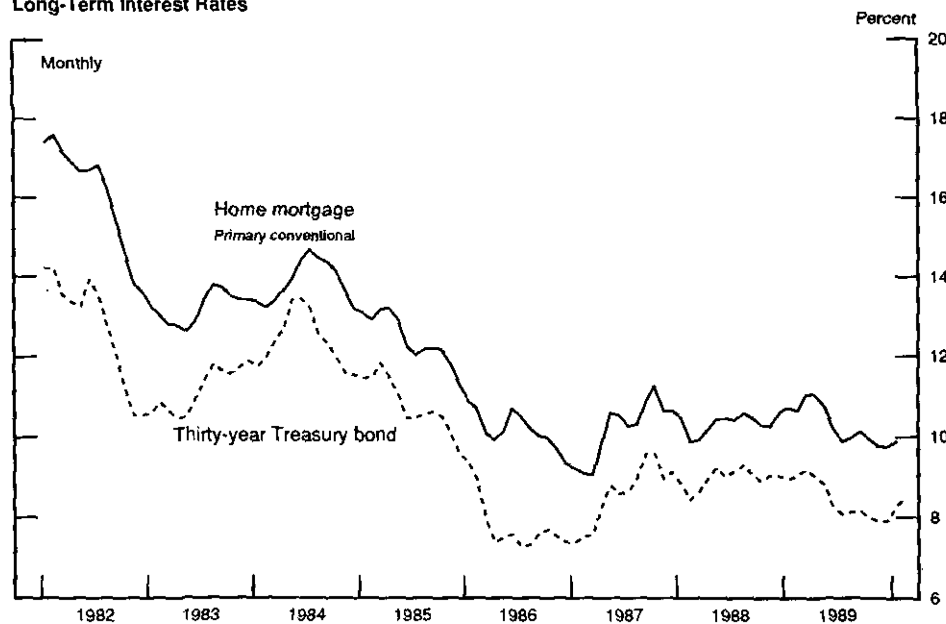

Observations are monthly averages of daily data;
last observation for January 1990.

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FOMC reduced pressures on reserve markets in three separate steps, which nudged the federal funds rate down to around 8¼ percent by year-end, about 1½ percentage points below its level when incremental tightening ceased in February. Over those ten months, other short- and long-term nominal interest rates fell about 1 to 1¼ percentage points; and most major stock price indexes reached record highs at the turn of the year, more than recovering the losses that occurred on October 13. Reflecting some reduction in inflation anticipations over the same period, estimated short- and long-term real interest rates fell somewhat less than nominal rates, dropping probably about ½ to ¾ percentage point. Still, most measures of short- and long-term real interest rates remained well above their trough levels of 1986 and 1987 – levels that had preceded rapid growth in the economy and a buildup of inflationary pressures.

Over the last three months of the year and into January 1990, the foreign exchange value of the dollar declined substantially from its high, which was reached around midyear and largely sustained through September. The dollar fell amid concerted intervention undertaken by the G-7 countries in the weeks immediately after a meeting of the finance ministers and central bank governors of these countries in September. The dollar continued to decline in response to the easing of short-term interest rates on dollar assets and increases in rates in Japan and Germany. The German currency rate rose particularly sharply as developments in Eastern Europe were viewed as favorable for the West German economy, attracting global capital flows. Rising interest rates in Germany likely contributed to an increase in bond yields in the United States early in 1990, even as U.S. short-term rates remained essentially unchanged. More important, however, for the rise in nominal, and likely real, long-term rates in the United States were incoming data pointing away from recession in the economy and from any abatement in price pressures, especially as oil prices moved sharply higher.

Behavior of Money and Credit

Growth in M2 was uneven over 1989, with marked weakness in the first part of the year giving way to robust growth thereafter. On balance over the year, M2 expanded 4½ percent, down from 5¼ percent growth in 1988, placing it about at the midpoint of its 1989 target range of 3 to 7 percent. The slower rate of increase in M2 reflected some moderation in nominal income growth as well as the pattern of interest rates and associated opportunity costs of holding money, with the effects of increases in 1988 and 1989 outweighing the later, smaller, drop in rates.

M2 has grown relatively slowly over the past three years, as the Federal Reserve has sought to ensure progress over time toward price stability. There appears to be a fairly reliable long-term link between M2 and future changes in inflation. One method of specifying that link is to estimate the equilibrium level of prices implied by the current level of M2, assuming that real GNP is at its potential and velocity is at its long-run average, and compare that to actual prices. The historical record suggests that inflation tends to rise when actual prices are below the equilibrium level and to moderate when equilibrium prices are below actual. At the end of 1986, the equilibrium level of prices was well above the actual level, reinforcing the view that the risks weighed on the side of an increase in inflation; at the end of 1989, that equilibrium price had moved into approximate equality with the actual price level, indicating that basic inflation pressures had steadied.

In 1989, compositional shifts within M2 reflected the pattern of interest rates, the unexpected volume of tax payments in the spring, and the flow of funds out of thrift deposits and into other instruments. Early in the year, rising market interest rates buoyed the growth of small-denomination time deposits at the expense of more liquid deposits, as rates on the latter accounts adjusted only sluggishly to the upward market movements. The unexpectedly large tax payments in April and May contributed to the weakness in liquid instruments, as those balances also were drawn down to meet tax obligations. As market interest rates fell, the relative rate advantage reversed in favor of liquid instruments and the growth in liquid deposits rebounded, boosted as well by the replenishment of accounts drained by tax payments.

The M1 component of M2 was especially affected by the swings in interest rates and opportunity costs last year, and in addition was buffeted by the effects of outsized tax payments in April. After its 4¼ percent rise in 1988, M1 grew only ½ percent in 1989, with much of the weakness in this transactions aggregate occurring early in the year. By May, M1 had declined at about a 2½ percent annual rate from its fourth-quarter 1988 level, reflecting a lagged response to earlier increases in short-term interest rates and an extraordinary bulge in net individual tax remittances to the Treasury. From May to December, M1 rebounded at a 4 percent rate as the cumulating effects of falling interest rates and post-tax-payment rebuilding boosted demands for this aggregate. M1 velocity continued the upward trend that resumed in 1987, increasing in the

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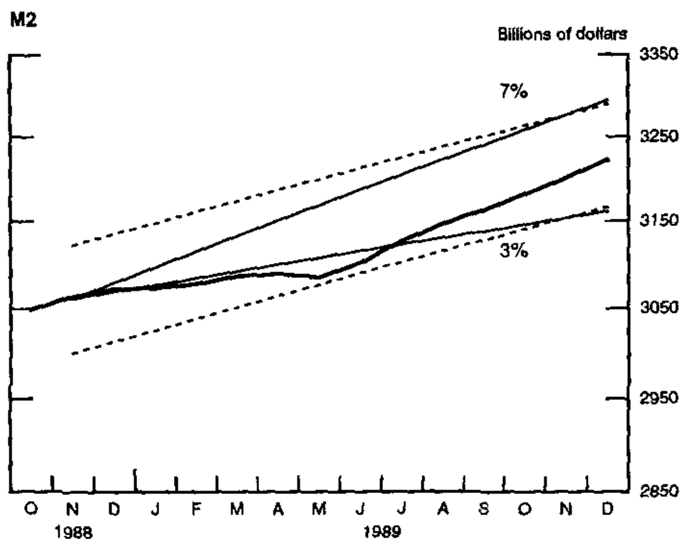
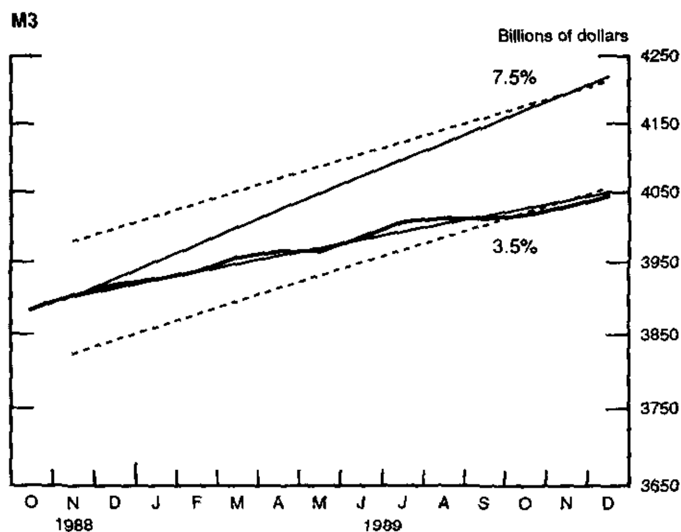
M2 and M3: Target Ranges and Actual Growth



Rate of growth

1988:4 to 1989:4
4.6 percent



Rate of growth

1988:4 to 1989:4
3.3 percent

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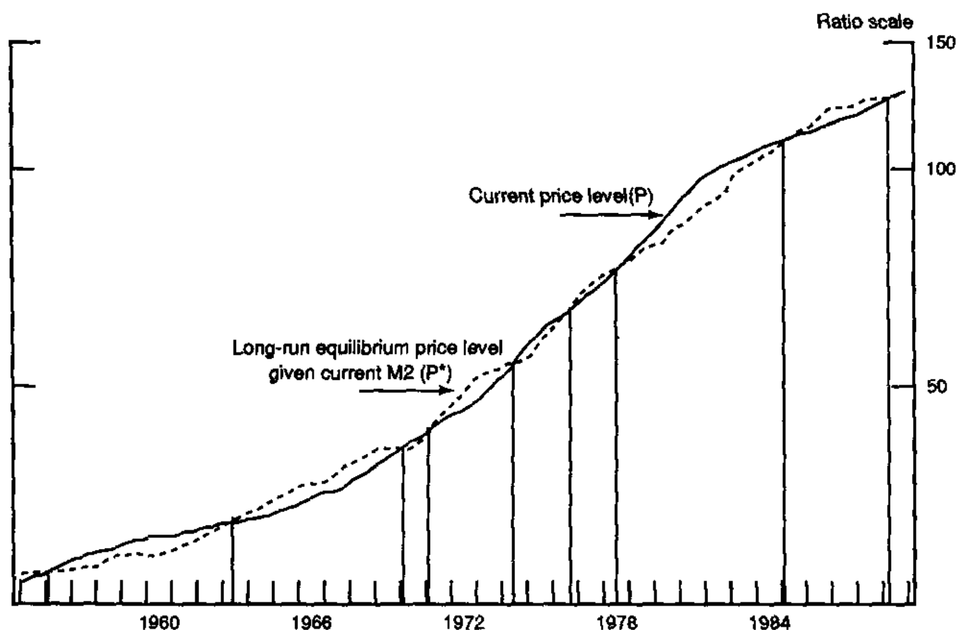
Inflation Indicator Based on M2



The current price level (P, the solid line) is the implicit GNP deflator, which is set to 100 in 1982.

The long-run equilibrium price level given current M2 (P*, the dashed line) is calculated as $P^* = (M2 \cdot V^*)/Q^*$, where V^* is an estimate of the long-run value of the GNP velocity of M2—the mean of V2 from 1955:1 to 1988:1—and Q^* is a Federal Reserve Board staff measure of potential real GNP.

The vertical lines mark the quarters when the difference between the current price level (P) and the long-run equilibrium price level (P*) switches sign, and thus when inflation, with a lag, tends to begin accelerating or decelerating.

For more details, see Jeffrey J. Hallman, Richard D. Porter, and David H. Small, *M2 per Unit of Potential GNP as an Anchor for the Price Level*, Staff Studies 157 (Board of Governors of the Federal Reserve System. 1989).

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first three quarters before turning down in the fourth quarter of 1989.

The shift of deposits from thrift institutions to commercial banks and money fund shares owed, in part, to regulatory pressures that brought down rates paid by some excessively aggressive thrifts. Beginning in August, the newly-created Resolution Trust Corporation (RTC) targeted some of its funds to pay down high-cost deposits at intervened thrifts and began a program of closing insolvent thrifts and selling their deposits to other institutions – for the most part, banks. On balance, the weak growth of retail deposits at thrifts appears to have been about offset by the shift into commercial banks and money market mutual funds, leaving M2 little affected overall by the realignment of the thrift industry.

M3 was largely driven, as usual, by the funding needs of banks and thrifts; under the special circumstances of the restructuring of the thrift industry, it was a less reliable barometer of monetary policy pressures than is normally the case. After expanding 6¼ percent in 1988, M3 hugged the lower bound of its 3½ to 7½ percent target cone in 1989, closing the year about 3¼ percent above its fourth quarter-1988 base. In 1989, bank credit growth about matched the previous year's 7½ percent increase, but credit at thrift institutions is estimated to have contracted a bit on balance over the year, in contrast to its 6¼ percent growth in 1988. This weakness in thrift credit directly owed to asset shrinkage at SAIF-insured savings and loan institutions; credit unions and mutual savings banks expanded their balance sheets in 1989. In addition, funds paid out by the RTC to thrift institutions and to banks acquiring thrift deposits directly substituted for other sources of funds. As a result, thrifts lessened their reliance on managed liabilities, as evidenced by the 14¾ percent decline over the year in the sum of large time deposits and RPs at thrifts. Institution-only money market mutual funds were bolstered by a relative yield advantage, as fund returns lagged behind declining market interest rates in the second half of the year; these funds provided the major source of growth for the non-M2 component of M3. On balance, the effects of the thrift restructuring dominated the movements in M3, and the rebound in M2 in the second half of the year did not show through to this broader aggregate. As a consequence, the velocity of M3 increased 3 percent in 1989, 1¼ percentage points faster than the growth in M2 velocity, and its largest annual increase in twenty years.

Many of the assets shed by thrifts were mortgages and mortgage-backed securities, but this appears to have had little sustained effect on home mortgage cost and availability. The spread between the rate on primary fixed-rate mortgages and the rate on ten-year Treasury notes rose somewhat early in the year, but thereafter remained relatively stable. The share of mortgages held in securitized form again climbed in 1989, facilitating the tapping of a base of investors. Diversified lenders, acting in part through other intermediaries, such as federally-sponsored agencies, mostly filled the gap left by the thrifts. However, some shrinkage of credit available for acquisition, development, and construction appeared to follow from FIRREA-imposed limits on loans by thrifts to single borrowers, though the reduction in funds available for these purposes probably also reflected problems in some residential real estate markets.

Aggregate debt of the domestic nonfinancial sectors grew at a fairly steady pace over 1989, averaging 8 percent, which placed it near the midpoint of its monitoring range of 6½ to 10½ percent. Although the annual growth of debt slowed in 1989, as it had during the preceding two years, it still exceeded the 6½ percent growth of nominal GNP. Federal sector debt grew 7½ percent, about ½ percentage point below the 1988 increase—and the lowest rate of expansion in a decade—as the deficit leveled off. Debt growth outside the federal sector eased by more to average 8¼ percent, mostly because of a decline in the growth of household debt. Mortgage credit slowed in line with the reduced pace of housing activity, and consumer credit growth, though volatile from month to month, trended down through much of the year. The growth of nonfinancial business debt slipped further below the extremely rapid rates of the mid-1980s. Corporate restructuring continued to be a major factor buoying business borrowing, although such activity showed distinct signs of slowing late in the year as lenders became more cautious and the use of debt to require equity ebbed.

The second half of 1989 was marked by the troubling deterioration in indicators of financial stress among certain classes of borrowers, with implications for the profitability of lenders, including commercial banks. In the third quarter, several measures of loan delinquency rates either rose sharply or continued on an uptrend. Delinquency rates on closed-end consumer loans at commercial banks and auto loans at "captive" auto finance companies were close to historically high levels. At commercial banks as a whole in 1989, both delinquency and charge-off rates for real estate loans were little changed from the previous year. Still, problem real estate loans continued to be a drag on the profitability of banks in Texas, Oklahoma, and Louisiana; in the second half, such loans emerged as a serious

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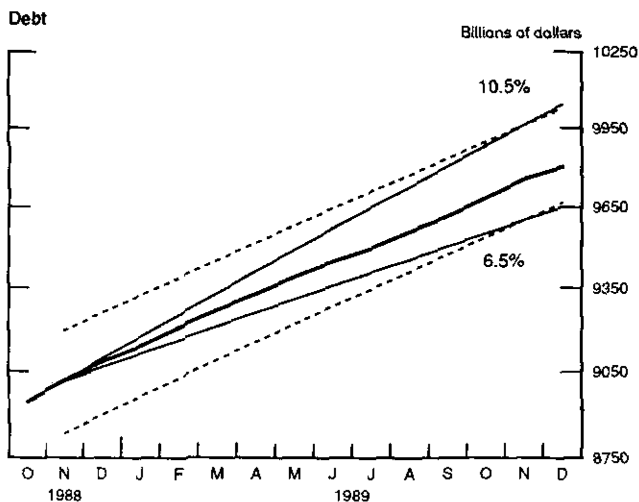
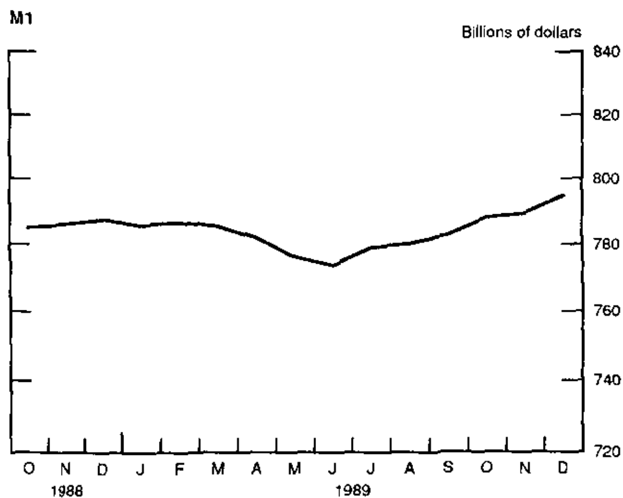
Debt: Monitoring Range and Actual Growth



Rate of growth

1988:4 to 1989:4
8.1 percent

M1: Actual Growth



Rate of growth

1988:4 to 1989:4
0.6 percent

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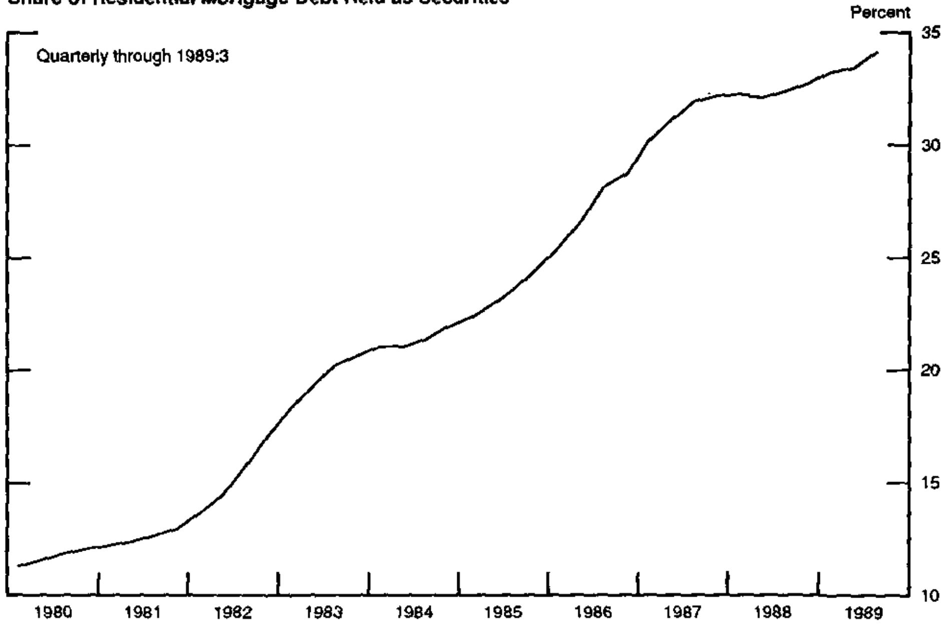

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problem for banks in New England. On the other hand, smaller, agriculturally oriented banks continued to recover from the distressed conditions of the mid-1980s. Since 1987, agricultural banks have charged off loans at well below the national rate, and their nonperforming assets represented a smaller portion of their loans than that for the country as a whole.

The upswing in the profitability of insured commercial banks that began in 1988 only extended through the first half of 1989. A slowing in the buildup of loan-loss provisions, along with improvements in interest-rate margins, contributed to these gains, with the money center banks showing the sharpest turnaround. Information for the second half of 1989, although still incomplete, clearly points to an erosion of these profit gains, in part, because of problems in the quality of loans. Several money center banks sharply boosted their loss provisions on loans to developing countries, while evidence of rising delinquency rates on real estate and consumer loans suggested more widespread weakening. Despite these developments, the spread of rates on bank liabilities, certificates of deposit and Eurodollar deposits, over comparable Treasury bill rates narrowed early in 1990.

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Growth of Money and Debt *(Percent Change)*

		M1	M2	M3	Debt of domestic nonfinancial sectors
Fourth quarter to fourth quarter					
1980		7.4	8.9	9.5	9.5
1981		5.4 (2.5)*	9.3	12.3	10.2
1982		8.8	9.1	9.9	9.1
1983		10.4	12.2	9.8	11.1
1984		5.4	7.9	10.6	14.2
1985		12.0	8.9	7.8	13.1
1986		15.5	9.3	9.1	13.2
1987		6.3	4.3	5.8	9.9
1988		4.3	5.2	6.3	9.2
1989		0.6	4.6	3.3	8.1
Quarterly growth rates (annual rates)					
1989	Q1	−0.1	2.3	3.9	8.4
	Q2	−4.4	1.6	3.3	7.9
	Q3	1.8	6.9	3.9	7.2
	Q4	5.1	7.1	2.0	8.0

*Figure in parentheses is adjusted for shifts to NOW accounts in 1981.

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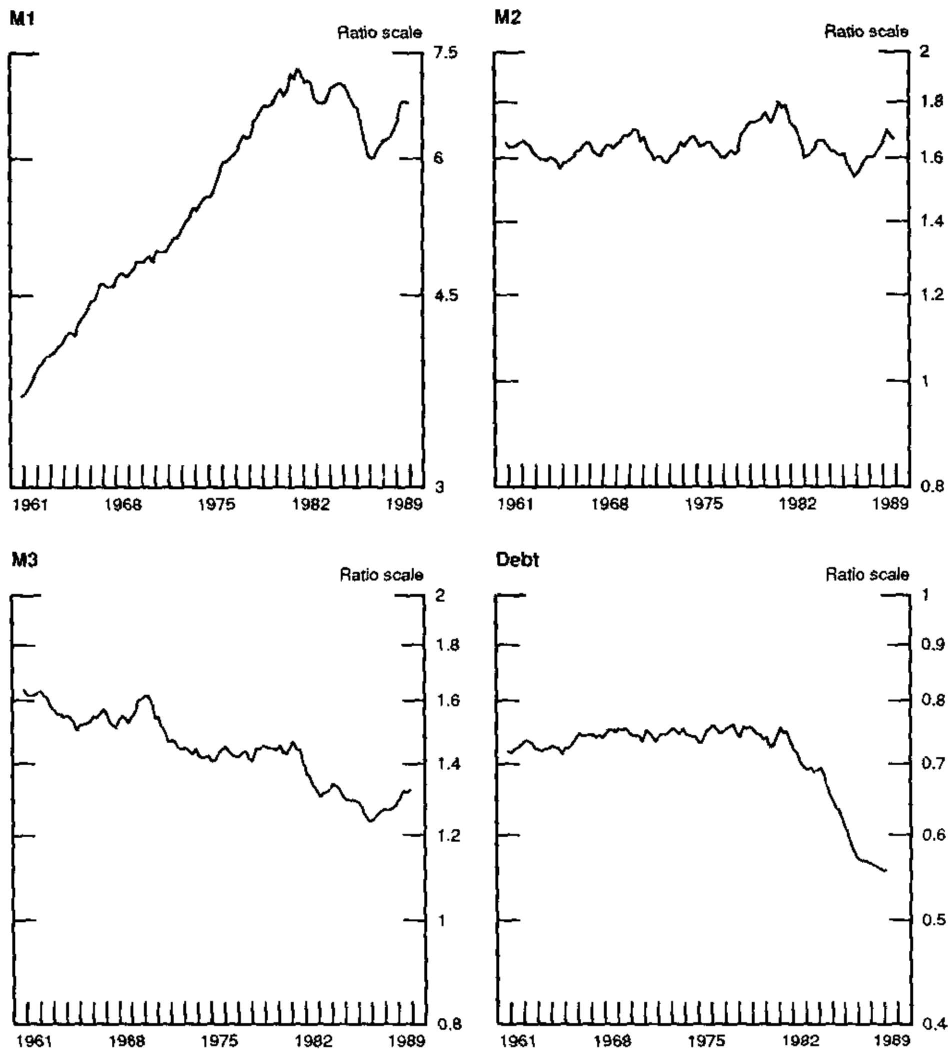

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RECORD OF POLICY ACTIONS OF THE
FEDERAL OPEN MARKET COMMITTEE

Meeting Held on February 6-7, 1990

1. Domestic policy directive

The information reviewed at this meeting suggested continued but sluggish expansion in overall economic activity, with conditions uneven across sectors. Industrial activity remained weak, partly because of the depressing effects of an inventory correction on manufacturing output, while the service-producing sector of the economy continued to grow moderately. Aggregate price measures had increased more slowly over most of the second half of 1989, but unusually cold weather in December put temporary upward pressure on food and energy prices. The latest data on labor compensation suggested no significant change in prevailing trends.

Total nonfarm payroll employment increased substantially in January after growing at a reduced pace on average in previous months. Employment surged in the service-producing sector, and unusually warm weather brought a rebound in hiring in the construction industry. These increases more than offset a large decline in factory jobs associated with sizable short-term layoffs in the motor vehicle and related industries. The civilian unemployment rate remained at the 5.3 percent level that had prevailed over most of 1989.

Partial data for January indicated that industrial production fell sharply. Automobile producers cut back temporarily on assemblies to help reduce bulging inventories of unsold vehicles, and the January thaw in the weather apparently brought a reduction in the generation of

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electricity that more than reversed a December surge. Abstracting from a number of transitory factors affecting production in recent months, industrial activity had changed little since the third quarter, although recent orders data suggested some underlying support for manufacturing output over the near term. Total industrial capacity utilization remained at a relatively high level in the fourth quarter but was down somewhat from its level a year earlier.

Adjusted for inflation, consumer spending was little changed in the fourth quarter. Strong gains in spending for services offset declines in purchases of consumer goods, especially new cars and light trucks. Although some of the strength in the services category reflected temporarily high energy-related expenditures, spending for medical and transportation services apparently remained strong throughout the fourth quarter. Near the end of the year, consumers responded positively to incentive programs introduced by automakers to reduce bloated inventories, and higher sales of domestically produced cars carried over to January. Residential construction in the fourth quarter was little changed from its third-quarter level, partly because December's unusually cold weather depressed single-family housing starts in that month. Multifamily starts remained at a low level as vacancy rates for such units moved still higher.

Business capital spending, adjusted for inflation, declined in the fourth quarter because of strike activity in the aircraft industry and sharply lower outlays for motor vehicles. Spending for equipment other than motor vehicles and aircraft rose; sizable increases were registered for computers and communications equipment, and moderate

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gains were evident for a wide variety of heavy machinery. A pickup toward the end of 1989 in new orders for equipment other than aircraft, and the return to work of striking aircraft workers, pointed to some improvement in equipment spending in the current quarter. Non-residential construction activity apparently weakened a little in the fourth quarter, partly reflecting the persisting high vacancy rates for office and other commercial space. Manufacturers' inventories fell in December after moderate increases in the two previous months; for the fourth quarter as a whole, increases in factory stocks were well below those for previous quarters in 1989. By contrast, nonauto retail stockbuilding accelerated late in the year, and there were reports that inventory-sales ratios at general merchandisers were higher than desired.

The nominal U.S. merchandise trade deficit rose slightly in November from a revised October level. For the two months together, the deficit was up substantially from the averages for both the third quarter and the first nine months of 1989. Total exports for the two-month period were little changed from their third-quarter level as a reduction in exports of aircraft, resulting from strike activity, offset moderate increases in a broad array of other products. Total imports increased rapidly in October-November, with imports of capital goods being especially strong. Indicators of economic activity in major foreign industrial countries were mixed during the fourth quarter of 1989. Growth continued strong in Japan, and most indicators pointed to

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renewed strength for Germany, Italy, and France. By contrast, growth was sluggish in the United Kingdom and Canada.

Producer prices for finished goods jumped in December, largely reflecting higher prices for energy products, most notably for heating oil. Abstracting from food and energy items, producer prices rose faster in December than in November, but the rate of increase in the fourth quarter as a whole remained at the reduced third-quarter pace. At the consumer level, prices rose somewhat more rapidly toward the end of 1989, and food and energy prices apparently increased substantially further in January. Among nonfood, non-energy categories, discounting of apparel and home furnishings was more than offset by a sharp rise in prices of new cars and by another month of sizable price increases for services.

At its meeting on December 18-19, 1989, the Committee adopted a directive that called for a slight easing in the degree of pressure on reserve positions but that provided for giving equal weight to subsequent developments that might require some easing or tightening during the intermeeting period. Accordingly, the Committee agreed that slightly greater or slightly lesser reserve restraint would be acceptable during the intermeeting period, depending on progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets. The contemplated reserve conditions were expected to be consistent with growth of M2 and M3 over the four-month period from November 1989 to March 1990 at annual rates of about 8-1/2 percent and 5-1/2 percent respectively.

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Immediately after the Committee meeting, open market operations were directed toward implementing the slight easing in the degree of pressure on reserve positions called for by the Committee. Reserve conditions then remained essentially unchanged over the rest of the intermeeting period. Adjustment plus seasonal borrowing averaged a little more than $300 million for the intermeeting period; the volume was boosted by reserve shortfalls, borrowing by large banks over the long holiday weekends, and, in the latter part of the interval, borrowing by a sizable bank whose normal access to liquidity had been impaired. The federal funds rate declined from about 8-1/2 percent at the time of the December meeting to around 8-1/4 percent shortly thereafter; except for some firming in the last week of 1989 owing to reserve shortfalls and year-end pressures, the funds rate remained in the vicinity of that lower level. Other private short-term market rates also declined over the period, including a 1/2 percentage point drop in the prime rate to 10 percent, while Treasury bill rates increased somewhat.

Yields on intermediate- and long-term debt instruments rose considerably over the intermeeting period. Some stronger-than-anticipated economic data and rising food and energy prices were interpreted in the financial markets as pointing away from recession and as suggesting little if any moderation in underlying inflation trends. Increases in interest rates abroad probably also had an influence on U.S. interest rates. Stock prices approached new highs at the start of the year but have fallen substantially since then.

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In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined further over the intermeeting period, as monetary conditions abroad tightened somewhat on average while those in the United States eased slightly. The dollar's movements against individual currencies were mixed; most of its depreciation occurred against the German mark, which continued to be buoyed by developments in Eastern Europe, and against related European currencies. On net, the U.S. dollar remained relatively firm against the yen and the Canadian dollar; the latter declined sharply as Canadian short-term interest rates edged lower amid signs of slow growth in the Canadian economy and a consequent easing of inflation pressures.

Growth of M2, measured on a benchmarked and seasonally revised basis, remained relatively strong in the fourth quarter of 1989; for the year, this aggregate expanded at a rate a little below the middle of the Committee's annual range. Partly as a result of further contraction in the assets and associated funding needs of thrift institutions, M3 grew more slowly in the fourth quarter and, for the year, expanded at a rate just below the lower bound of its annual range. In January, both of the broader aggregates increased at slower rates. A sharp drop in transactions deposits damped expansion of M2, even though retail-type savings deposits remained strong and money market funds evidently benefited from funds flowing out of weakening stock and bond markets. Growth of M3 in January slowed by less than that of M2.

The staff projection prepared for this meeting suggested that the economy was likely to expand relatively slowly over the next several quarters. In the near term, production adjustments to eliminate excess

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inventories, most notably in the motor vehicles industry, were expected to depress manufacturing activity and overall growth; some pickup in the expansion was anticipated after the inventory correction was completed, but final sales were projected to continue growing at a relatively sluggish pace. Homebuilding might rebound somewhat in the near term after being disrupted by December's cold weather, but prevailing interest rates and possible cutbacks in construction lending by thrifts likely would restrain residential construction activity throughout the year. The projection assumed that fiscal policy would be moderately restrictive and that net exports would make little contribution to growth of domestic production in 1990. The expansion of consumer demand would be damped by slow gains in employment and associated limited growth in real disposable incomes. With pressures on labor and other production resources expected to ease only gradually, little improvement was anticipated in the underlying trend of inflation over the next several quarters.

In their discussion of the economic situation and outlook, the Committee members generally agreed that continuing growth in economic activity remained a reasonable expectation for the year ahead. Several observed that, on the whole, recent indicators of business conditions provided some assurance that the expansion was no longer weakening and indeed that a modest acceleration might be under way from the considerably reduced growth experienced in the fourth quarter. The members acknowledged that there were considerable risks, stemming mainly from the financial side, of a weaker than projected expansion, and some did not rule out the possibility of a downturn. In the latter connection,

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several commented that they had observed a sense of unease and fragility in the business and financial communities arising from such factors as declining profit margins, heavy debt burdens, and problems in certain sectors of the financial markets that were contributing to greater caution on the part of lenders and a reduced availability of credit to some borrowers. With regard to the outlook for inflation, members remained generally optimistic that moderating pressures on labor and other resources would lead in time to a lower rate of inflation. However, most members saw little prospect that significant progress, if any, would be made in reducing the underlying rate of inflation in the quarters immediately ahead. Indeed, in part because of temporary pressures in the food and energy sectors, key measures of inflation might well register larger increases in the near term before turning down later.

In keeping with the usual practice at meetings when the Committee establishes its longer-run ranges for growth of the monetary and debt aggregates, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members had prepared projections of economic activity, the rate of unemployment, and inflation for the year 1990. In making these forecasts, the members took account of the Committee's policy of continuing restraint on demand to resist any increase in inflation pressures and to foster price stability over time. For the period from the fourth quarter of 1989 to the fourth quarter of 1990, the forecasts for growth of real GNP had a central tendency of 1-3/4 to 2 percent, a pace close to that experienced in 1989 excluding the direct effects of the rebound in farm output after

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the drought in 1988. Estimates of the civilian rate of unemployment in the fourth quarter of 1990 were concentrated in a range of 5-1/2 to 5-3/4 percent. The associated pressures on prices resulted in projected increases in the consumer price index centered on rates of 4 to 4-1/2 percent for the year, compared with a rise of 4-1/2 percent in 1989. Forecasts for growth of nominal GNP had a central tendency of 5-1/2 to 6-1/2 percent. The forecasts assumed that changes in the foreign exchange value of the dollar would not be of sufficient magnitude to have a significant effect on the economy or prices during 1990.

In the Committee's discussion of developments bearing on the economic outlook, the members emphasized that despite indications of continuing growth in overall business activity, there were obvious areas of weakness in the economy, notably in manufacturing across much of the nation and in construction in many localities. Business sentiment appeared to have deteriorated in some areas, perhaps more than was justified by actual developments. While local business conditions were clearly uneven, business activity was generally characterized as growing on an overall basis in the various regions, including recent evidence of a modest pickup in some previously depressed parts of the country.

With regard to individual sectors of the economy, the outlook for retail sales was clouded to some extent by the uncertain prospects for motor vehicles and the financial problems being experienced by some major retailers; nonetheless, in the context of expected further gains in disposable incomes, many members expected overall consumer spending to be relatively well maintained. Business inventories probably were falling in the current quarter, largely reflecting sharp declines in

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stocks of motor vehicles, but once the correction in that industry was completed, some renewed increases in overall inventory investment were anticipated in line with expanding sales. Current indicators suggested that business fixed investment might be reasonably well maintained, but it also was noted that overbuilding of commercial real estate in many areas would restrain overall nonresidential construction and more generally that depressed profits and cash flows could limit gains in business investment. Concerning the outlook for residential construction, conditions in local housing markets varied markedly and the prospects for the nation were difficult to assess. Negative developments included higher mortgage interest rates, a reduced availability of financing for many developers, and the overhang of large inventories of housing units held by the Resolution Trust Corporation (RTC). Nonetheless, housing demand was holding up in many areas and booming in a few, and on balance most members expected little change this year in overall expenditures for residential construction. A number commented that the prospects for exports were relatively bright; foreign demand was reported to be robust for many types of goods, and overall exports would be given some impetus over time by the depreciation of the dollar over the past several months.

Turning to the outlook for inflation, members noted that broad measures of labor compensation did not suggest any lessening of pressures. Unit labor costs appeared to be rising at a faster pace recently than the underlying rate of inflation, squeezing profit margins. Commodity prices displayed mixed changes but generally remained on a high plateau. Business contacts and broader surveys

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indicated a widespread expectation that the current rate of inflation would continue. Moreover, with higher social security taxes and a rising minimum wage adding to labor costs and earlier increases in producer food and energy costs not yet fully transmitted to retail prices, some measures of inflation were expected to show sharper increases over the near term. On the other hand, reports from a number of business contacts indicated that input prices, especially for raw materials, had stabilized or declined in recent months. More generally, a number of members commented that continued limited growth in business activity at a time of uncertainties and concerns associated with various financial problems and declining real estate values in many areas should contribute to some restraint in overall inflationary behavior.

Against the background of the members' views on the economic outlook and in keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act), the Committee reviewed the ranges that it had established on a tentative basis in July 1989 for growth of the monetary and debt aggregates in 1990. The tentative ranges, which were unchanged from those for 1989, included expansion of 3 to 7 percent for M2 and 3-1/2 to 7-1/2 percent for M3, measured from the fourth quarter of 1989 to the fourth quarter of 1990. The monitoring range for growth of total domestic nonfinancial debt had been set at 6-1/2 to 10-1/2 percent, also unchanged from 1989.

With regard to M2, on which much of the discussion was focused, a majority of the members concluded that retention of the tentative range of 3 to 7 percent would best assure the flexibility that the Committee was likely to need to implement its policy objectives during

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the year. A staff analysis prepared for this meeting indicated that, were interest rates to remain near recent levels, a somewhat higher rate of M2 growth than had occurred in any of the past three years was likely to be consistent with some reduction in the expansion of nominal GNP. According to this analysis, the lagged effects of earlier declines in market interest rates would continue to boost M2 growth in the first part of 1990, and the velocity of M2 was likely to fall for the year as a whole. To the extent that the projected weakness in M2 velocity turned out to be correct, it implied M2 growth toward the upper end of the tentative range on the basis of the central tendency of the members' forecasts of nominal GNP.

Given this outlook, an unchanged range for M2 still left considerable leeway for the Committee to embark on a more aggressive policy to restrain inflation, should developments during the year suggest an intensification of inflationary pressures or provide an opportunity to tilt the implementation of policy toward greater restraint and faster progress against inflation without impairing the forward momentum of the economy. Thus, although the Committee recognized that over time lower ranges and slower M2 growth would be compatible with price stability, retention of the current range did not signal a diminished determination to move toward the objective of price stability.

Preferences for slightly higher or somewhat lower ranges for M2 also were expressed. The arguments in favor of a higher range focused on the risks of a weaker economy than was anticipated currently and the related desirability of more maneuvering room for an easing of short-run

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policy if such were needed to help avert a cumulative deterioration in economic activity. In those circumstances, faster monetary growth would not be inconsistent with the Committee's long-term commitment to price stability. Other members believed that a somewhat reduced range would allow adequate growth in M2 to sustain moderate expansion in economic activity and would provide a desirable signal of the System's commitment to an anti-inflationary policy. In this connection, the credibility of the System's anti-inflationary policy was seen as an important channel for reducing inflationary expectations directly and thereby lessening the economic costs and time needed to achieve price stability. These members expressed concern that growth around the upper end of a 3 to 7 percent range might well preclude any progress in reducing inflation this year and might make it more difficult to achieve such progress later. For some of these members, however, a 3 to 7 percent range would be acceptable if its upper limit was viewed as a firm constraint on actual growth and if a clear explanation was made of the Committee's commitment to achieve price stability over time.

Turning to the ranges for M3 and debt, most of the members indicated that they favored or could accept reductions from the tentative ranges that had been adopted in July 1989 for this year. Some reduction in the range for M3 was thought to be consistent with an unchanged range for M2 for technical reasons associated with the restructuring of the thrift industry and related shrinkage in thrift institution balance sheets. Declines in thrift institution assets and associated funding needs, including liabilities in M3, now seemed likely to be larger in 1990 than had been anticipated last summer, reflecting

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continued efforts of solvent institutions to meet capital standards as well as the closing of insolvent institutions. Beyond that, while a reduction in the M3 range, especially if it was limited, might have little implication for policy, many members believed that the Committee should take advantage of every opportunity to reduce its ranges toward levels that were consistent with price stability. With regard to the monitoring range for total domestic nonfinancial debt, the members expected the expansion of such debt to moderate for a fourth year in 1990, in large measure because of anticipated reductions in debt creation associated with corporate merger and acquisition activities but also because of some probable ebbing in the growth of household debt. The prospect of slower growth of debt was welcome, given concerns about strains associated with highly leveraged borrowers and high debt servicing obligations.

A few members indicated a preference for retaining the somewhat higher ranges for M3 and debt that had been adopted on a tentative basis for this year. In their view, lowering those ranges would tend to send potentially confusing signals, raising questions as to why the M2 range was not reduced also. Also, disparate adjustments in the ranges for the various aggregates could foster an unwarranted impression of the precision with which the Committee felt it could evaluate the ranges.

The members generally agreed that setting 1990 target ranges for M2 and particularly for M3 was rendered more difficult by uncertainty about developments affecting thrift institutions, especially given the relatively limited basis in past experience for gauging the likely impact of such developments. The establishment of an appropriate

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range for the growth of nonfinancial debt also was complicated by uncertainty about the extent to which Treasury borrowing would be used to carry the assets of failed thrift institutions as opposed to funding from financial-sector sources through the RTC. With these questions adding to the usual uncertainty about the relationship of movements in the aggregates to broad measures of economic performance, the Committee decided to retain the 4 percentage point width of the ranges. It also agreed that the implementation of policy should continue to take into account, in addition to monetary growth and its velocity, indications of inflationary pressures in the economy, the strength of business activity, and developments in domestic and international financial markets.

At the conclusion of the Committee's discussion, a majority of the members indicated that they favored or could accept the M2 range for 1990 that had been established on a tentative basis in July 1989 and reductions of one percentage point and 1-1/2 percentage points respectively in the tentative ranges for M3 and nonfinancial debt. Accordingly, the Committee approved the following paragraph relating to its 1990 ranges for inclusion in the domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability, 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 this meeting established ranges for growth of M2 and M3 of 3 to 7 percent and 2-1/2 to 6-1/2 percent respectively, measured from the fourth quarter of 1989 to the fourth quarter of 1990. The monitoring range for growth of total domestic nonfinancial debt was set at 5 to 9 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progess toward price stability, movements in their velocities, and developments in the economy and financial markets.

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Votes for this action: Messrs. Greenspan, Corrigan, Angell, Boehne, Boykin, Johnson, Kelley, and LaWare. Votes against this action: Mr. Hoskins, Ms. Seger, and Mr. Stern.

Messrs. Hoskins and Stern dissented because they wanted a lower range for M2. They were concerned that growth around the upper end of a 3 to 7 percent range would not be compatible with progress in reducing the rate of inflation this year. An upper limit of 6 percent would be preferable and would provide adequate room in their view for policy to foster sustained economic expansion. Mr. Hoskins also stressed the desirability of a predictable and credible monetary policy, which he believed should include persistent reductions in the ranges to levels that would be consistent with stable prices. The favorable effects of such a policy on inflationary expectations would tend to lessen the costs and also accelerate the achievement of price stability.

Ms. Seger dissented because she believed that the M2 range should be raised to at least 3-1/2 to 7-1/2 percent. In her view the considerable downside risks to the expansion called for some added room to accommodate the possible need for a more stimulative policy and somewhat faster M2 growth than was contemplated by an unchanged range. In particular, a shortfall in aggregate demands during the first half of the year might well require some easing of policy aimed at countering developing weakness in the economy. In such circumstances, M2 growth somewhat above 7 percent would not be inconsistent with the Committee's anti-inflation objective. She could accept unchanged ranges for growth of M3 and nonfinancial debt, given the outlook for somewhat slower expansion of both aggregates in relation to M2 than the Committee had anticipated in July 1989.

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Turning to policy implementation for the intermeeting period ahead, a majority of the members favored steady reserve conditions. Given indications of some pickup in activity from the latter part of 1989, such a policy offered the best prospects at this point of reconciling the Committee's objective of acceptable and sustained economic growth with that of some reduction over time in inflationary pressures on labor and other resources. A tightening of policy might have some advantages in terms of moderating monetary growth and improving inflationary expectations, but in this view such a policy would incur too much risk of creating financial conditions that could lead to a weaker economy. Conversely, significantly lower interest rates could have inflationary consequences in an economy that already was operating at relatively high employment levels, partly through their effects on the dollar in the foreign exchange markets. Conditions in the economy and in financial markets, both in the United States and abroad, suggested that monetary policy needed to convey a sense of stability.

Other members acknowledged that adjustments in monetary policy needed to be made with a special degree of caution in current circumstances, but on balance they assessed the risks and the related advantages and disadvantages of a change in policy somewhat differently. In one view, the risks of a recession argued for a prompt adjustment toward somewhat less monetary restraint, especially given the need to bolster relatively interest-sensitive sectors of the economy such as housing and motor vehicles. A differing view focused on the desirability of a somewhat tighter policy at this juncture, particularly in

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light of the outlook for relatively little progress against inflation as the business expansion tended to strengthen. One member gave special emphasis to the desirability of limiting M2 growth to a path closer to the middle of the Committee's range for 1990 to help assure that progress would be made this year in moderating inflationary pressures.

In the Committee's consideration of possible adjustments to the degree of reserve pressure during the intermeeting period, a majority of the members supported a directive that did not contain any bias toward tightening or easing. They felt that a symmetric instruction was consistent at this point with their general preference for a stable policy and that an intermeeting adjustment should be made only in the event of particularly conclusive economic or financial evidence, including a substantial deviation in monetary growth from current expectations. One member who preferred a slightly tighter policy indicated that an unchanged policy that was biased toward restraint would be acceptable.

Members noted that seasonal borrowing was likely to turn up from its January lows so that some increase in the total of adjustment plus seasonal borrowing would be associated with a given degree of reserve restraint and a given federal funds rate. It was understood that some increase in the borrowing assumption would be made at the start of the intermeeting period and that further adjustments might be made later during the period, subject to the Chairman's review. In keeping with the usual practice, persisting borrowings by troubled depository institutions that had not been classified as extended credit would be treated as nonborrowed reserves in setting target growth paths

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for reserves. More generally, in light of the uncertainties that were involved, the Manager would continue to exercise flexibility in his approach to the borrowing assumption.

At the conclusion of the Committee's discussion, a majority of the members indicated that they favored or could accept a directive that called for an unchanged degree of pressure on reserve positions. Some firming or some easing of reserve conditions would be acceptable during the intermeeting period depending on progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets. The reserve conditions contemplated by the Committee were expected to be consistent with growth of M2 and M3 at annual rates of around 7 and 3-1/2 percent respectively over the three-month period from December to March. The members agreed that the intermeeting range for the federal funds rate, which provides one 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 Committee's 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 is continuing to expand despite weakness in the industrial sector. Total nonfarm payroll employment increased substantially in January after growing at a reduced pace on average in previous months; a surge in the service-producing sector and a weather-related rebound in construction were only partly offset by a large decline in the manufacturing sector. The civilian unemployment rate was unchanged at 5.3 percent. Partial data suggest that industrial production in January was appreciably below its average in the fourth quarter. Adjusted for inflation, strong gains in consumer spending on

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services in the fourth quarter offset declines in consumer purchases of goods, especially motor vehicles. Unusually cold weather depressed housing starts appreciably in December, and residential construction in the fourth quarter was little changed from its third-quarter level. Business capital spending, adjusted for inflation, declined in the fourth quarter as a result of lower expenditures on motor vehicles and strike activity in the aircraft industry; spending on other types of capital goods was strong, however, and new orders for equipment picked up toward the end of the year. The nominal U.S. merchandise trade deficit widened in October-November from the third-quarter rate. Consumer prices had risen somewhat more rapidly toward the end of 1989, and prices of food and energy apparently increased substantially further in January. The latest data on labor compensation suggest no significant change in prevailing trends.

Interest rates have risen in intermediate- and long-term debt markets since the Committee meeting on December 18-19; in short-term markets, the federal funds rate has declined, and other short-term rates show mixed changes over the period. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined further over the intermeeting period; most of the depreciation was against the German mark and related European currencies, and there was little change against the yen.

Growth of M2 slowed in January, almost entirely reflecting a drop in transaction deposits. Growth of M3 also slowed in January as assets of thrift institutions and their associated funding needs apparently continued to contract. For the year 1989, M2 expanded at a rate a little below the middle of the Committee's annual range, and M3 grew at a rate slightly below the lower bound of its annual range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability, 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 this meeting established ranges for growth of M2 and M3 of 3 to 7 percent and 2-1/2 to 6-1/2 percent respectively, measured from the fourth quarter of 1989 to the fourth quarter of 1990. The monitoring range for growth of total domestic nonfinancial debt was set at 5 to 9 percent for the year. The behavior of the monetary aggregates will continue

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to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, slightly greater reserve restraint or slightly lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth of M2 and M3 over the period from December through March at annual rates of about 7 and 3-1/2 percent respectively. 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 the paragraph on short-term policy implementation: Messrs. Greenspan, Corrigan, Angell, Boehne, Johnson, Kelley, LaWare, and Stern. Votes against this action: Messrs. Boykin and Hoskins and Ms. Seger.

While taking account of the various elements of weakness and fragility in the economy, Mr. Boykin dissented because he preferred a policy directive tilted toward increased reserve pressures should economic and financial conditions warrant. This view was based on his concerns regarding the lagged effects of policy actions and the risks of delaying decisions until there was full confirmation of inflationary pressures. In this context, Mr. Boykin expressed his preference for dealing promptly with inflation if the Committee wished to make progress toward its long-stated goal of lowering the rate of inflation.

Mr. Hoskins dissented because he preferred some firming of reserve conditions. He recognized that there was some financial

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fragility in the economy, but he believed that underlying inflation pressures were relatively strong and that the balance of risks pointed to a need for greater monetary restraint to curb such inflation. He emphasized the desirability of tightening monetary policy gradually to reduce monetary growth to a pace closer to the midpoint of the Committee's range for the year.

Ms. Seger's dissent reflected a preference for some easing of reserve conditions at this point. In her view, even a limited decline in interest rates would provide timely assistance to relatively weak, interest-sensitive sectors of the economy such as housing and motor vehicles and would tend to sustain the expansion itself without adding to inflation risks in the economy.

2. Review of Continuing Authorizations

The Committee followed its customary practice of reviewing all of its continuing authorizations and directives at this first regular meeting of the Federal Open Market Committee following the election of new members from the Federal Reserve Banks to serve for the year beginning January 1, 1990. The Committee reaffirmed the authorization for foreign currency operations, the foreign currency directive, and the procedural instructions with respect to foreign currency operations in the forms in which they were currently outstanding.

Votes for this action: Messrs. Greenspan, Corrigan, Angell, Boehne, Boykin, Hoskins, Johnson, Kelley, LaWare, Ms. Seger and Mr. Stern. Votes against this action: None.

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3. Authorization for Domestic Open Market Operations

On the recommendation of the Manager for Domestic Operations, the Committee amended paragraph 1(a) of the authorization for domestic open market operations to raise from $6 billion to $8 billion the limit on intermeeting changes in System account holdings of U.S. government and federal agency securities. The increase was the first permanent change in the limit since March 1985 when it was raised from $4 billion to $6 billion. The Manager indicated that temporary increases had been authorized more frequently in recent years and that the existing limit also was approached more often during intermeeting intervals when no temporary increase was requested. A permanent increase to $8 billion would reduce the number of occasions requiring special Committee action, while still calling needs for particularly large changes to the Committee's attention. The Committee concurred in the Manager's view that a $2 billion increase would be appropriate.

Accordingly, effective February 6, 1990, paragraph 1(a) of the authorization for domestic open market operations was amended to read as follows:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U. S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U. S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U. S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a

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domestic policy directive shall not be increased or decreased by more than $8.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

> Votes for this action: Messrs. Greenspan, Corrigan, Angell, Boehne, Boykin, Hoskins, Johnson, Kelley, LaWare, Ms. Seger and Mr. Stern. Votes against this action: None.

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