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Monetary Policy Objectives for 1986

Testimony of Paul A. Volcker, Chairman,
Board of Governors of the Federal Reserve System

July 23, 1986

Testimony of Paul A. Volcker, Chairman, Federal Reserve Board

I appreciate the opportunity to report once again on the conduct of monetary policy. I would first like to place that matter in the larger context of the performance of the United States and the world economy.

As you know, there have been marked contrasts in the economic performance of different sectors and regions of this country. Consumption has been strongly maintained, and there have been large increases in employment in the broad service sector. Housing is being built at a high rate. But industrial activity and business investment, which had leveled off last year, have declined over the last six months, and the agricultural and energy industries are under strong pressure. As a consequence, activity in some areas of the country has advanced rather strongly, while severe adjustments are taking place in the energy and agricultural belts.

The net result is that the overall economic growth rate in the United States moderated to about 3 percent through 1985 and early 1986, and apparently slackened further in the second quarter of this year. Moreover, growth in other major industrialized countries remained slower than in the U.S. during 1985 and the early part of this year.

Throughout this period, sizable increases in employment have continued in this country; the unemployment rate has remained generally at a little over 7 percent and, relative to the size of the working age population, more people are employed than ever before recorded. In Europe, unemployment has also remained relatively steady, but at much higher levels.

After more than three years of economic expansion, the process of disinflation has continued, reinforced for the time being by sharply lower prices of oil, by far the most important commodity. With industrial prices steady, the average level of wholesale prices has been declining here, and even faster in key countries abroad whose currencies have been sharply appreciating relative to the dollar. Interest rates here and abroad have also declined appreciably, reflecting both the sense of progress against inflation and the fact that growth has been proceeding well within capacity restraints.

The large decline in U.S. interest rates and the sharply higher stock market over the past year suggest the cost of capital has declined. The fall in oil prices has helped bolster the real income of consumers. Meanwhile, the substantial depreciation of the dollar has placed our industry in a decidedly better competitive position vis-á-vis other industrial countries. As many have suggested, these underlying forces should help sustain an economic expansion that has already lasted longer than most.

But I would be remiss in failing to emphasize much less satisfactory aspects of the U.S. and world economic situation. There can be no evading the fact that some fundamental economic adjustments must be made within our economy in the months and years ahead.

The clear challenge is to find the ways and means to work through those adjustments in a context of sustained growth while also consolidating and retaining the progress toward price stability. The conduct of U.S. monetary policy is obviously relevant to that process. But that single policy instrument cannot itself provide the

answer. Complementary approaches in the fiscal, trade and other policies of this country, and in the approaches of other countries, will be required as well. The hard fact is that, while the need for complementary actions to achieve the necessary adjustments in the United States and world economy seems to be more widely recognized, progress in coordinating action toward those aims has been limited.

Disequilibrium in the Industrial World

Some obvious imbalances have developed in the economies of the industrialized world. That is evident most of all in the enormous deficit in our external trade and current accounts, and in the counterpart surpluses of a few other countries. Unless dealt with effectively and constructively, growing market and political pressures will, sooner or later, inevitably have much more disturbing consequences.

The problem first clearly emerged some time ago. The powerful thrust of the strong U.S. economic expansion in 1983 and 1984 had spilled out abroad in the form of sharply rising imports, aided and abetted by the exceptional strength of the dollar internationally. There were, for awhile, benefits on all sides. At a time of slack demand at home, exports to us helped Europe and Japan to restore and maintain their growth. The United States also absorbed a disproportionate share of the necessary external adjustment efforts by the heavily indebted countries of Latin America. Those countries have sharply curtailed their imports since 1982, and they have become more competitive in markets for manufactured goods.

At the same time, the United States began to be the recipient of a growing flow of capital from abroad. That inflow, which pushed the dollar so high in the exchange markets until early 1985, had the practical effect of relieving potential pressures on our internal financial markets even in the face of the massive and growing federal deficit. Consequently, private investment and construction could expand. At the same time, the competitive pressure from imports encouraged strong cost-cutting and productivity efforts in the industrial sector. That has been one powerful factor accounting for the near stability of prices of manufactured goods over the past year or more.

We cannot, however, build a lasting foundation for sustained growth and stability on massive international dis-equilibrium—huge and rising trade deficits in the United States and counterpart surpluses abroad. Nor can we count on satisfying indefinitely so much of our own needs for capital by drawing so heavily on the savings generated elsewhere in the world—savings that have been so freely available in part only because internal growth in Europe and Japan has been relatively slow.

Today the imbalances and strains are clearly showing. The forward momentum of our economy has been sustained almost entirely by consumer spending and housing construction, both of which have been accompanied by unsustainably heavy borrowing. Savings meanwhile have remained at a relatively low level, even by past U.S. standards. For more than a year, industrial production in the United States has not grown appreciably, and there has been some decline in 1986. The pace of business investment has slackened.

Some of the relative weakness in industrial output and investment over the past six months can be attributed to temporary factors and to developments peculiar to the United States. For instance, some investment orders were speeded up late last year in anticipation of tax reform, and the debate on the nature of that reform has apparently led to some deferral of ordering this year. The boom in spending for computers has subsided and commercial construction, in response to large and growing vacancies of office space, is predictably declining. Probably much more important in recent months have been very sharp cutbacks in domestic oil exploration and investment, driving energy producing states into

recession-like conditions and affecting production of steel and equipment elsewhere as well.

But a large part of the difficulty stems from the continuing imbalances in the world economy. On the average, growth rates in major European economies and Japan were about 3/4 percent less than the reduced growth path of the United States during 1985 and the first quarter of 1986. However, the more disturbing contrast lies in the source of that growth.

In the United States, the rate of growth in *domestic* demand, while slowing in the third year of expansion, continued to average about 3¾ percent through that period. *Domestic* demand growth in the industrialized countries of Europe and Japan was significantly less—about 2½ percent. In the early part of this year, when their exports slackened, those countries grew not at all.

The plain implication is that our overall GNP growth rate was reduced by continuing deterioration in our trade and current account balances. With our current account deficit reaching a record $135 billion annual rate in the first quarter of this year, industrial production and investment were restrained. Meanwhile, foreign surpluses continued to build through much of the period, and as their exports have slowed, internal demand has not yet, in most of those countries, picked up the slack.

Prospects for investment and for manufacturing activity in the United States are heavily dependent on an improved trade outlook. The sharp decline in the dollar since its peak in early 1985 should help set the stage for such an improvement. There is evidence that U.S. producers find themselves in a stronger competitive position. However, the deterioration in actual trade in manufactured goods has slowed little.

The decline in the dollar is both relatively recent and from a very high level so the absence of a stronger response in trade so far is not entirely surprising. What is of concern is that the domestic markets of our major industrial competitors have remained so sluggish, raising a question as to the buoyancy of the markets for our exports and of their own growth prospects.

You are well aware that the present imbalance among industrial countries is reflected in strong protectionist pressures in the United States. Yet, as the President has so strongly emphasized, to abandon our tradition of relatively open markets would surely be to invite an unravelling of the international trading order. We would then have less trade and more inflation. With that, prospects for sustained growth both here and abroad would clearly be placed in jeopardy.

I know of the complaints about "unfair" trading practices of other countries. We need to deal with them energetically. But I also know the clear lesson of experience is that a protectionist retreat by the United States, the world's leading economic power, would invite recrimination and escalation. Certainly, the most effective and promising avenue for dealing with the trade complaints on all sides will be in the planned round of multilateral trade negotiations rather than in a tit-for-tat process of mutual retaliation.

Moreover, I believe it is demonstrable that, as a matter of relative importance, much more fundamental imbalances in the world economy than unfair trading practices are responsible for the present pattern of trade deficits and surpluses. Those underlying imbalances can only be dealt with by complementary economic policies, not protectionism.

Quite clearly it is in no one's interest—not the United States or other countries—that we seek better balance in our external accounts by deliberately restraining further our own growth rate. But it is also true that as things now stand, stronger *domestically generated* growth in the United States will not reduce the international imbalances. Taken alone, it would aggravate our trade deficit further, posing an even more difficult adjustment problem later.

As I suggested, the recent exchange rate changes can help us to escape that dilemma—they should work to improve our trade position and reduce the surpluses of others. In fact, faced with a combination of appreciating currencies and slower growth in overseas markets, exporters in both Japan and some European countries are experiencing reduced profits and more sluggish orders from abroad. However, in the absence of offsetting internal sources of expansion, those same pressures could dampen their own prospects for growth.

That is one of several reasons we should not rely on exchange rate changes *alone* to produce the needed international adjustments in the world economy. Over a number of years, we in the United States will certainly need to shift more of our resources into exports, and into recovering domestic markets where import penetration has been so high. That, very broadly, implies relatively more growth in manufacturing; relatively less growth in services, in governmental spending, or in other sectors; and more savings and less borrowing. For some of the rest of the world, the opposite shift will need to be at work—less reliance on exports, and more on domestic sources of growth.

Much still needs to be done to ease the way for those adjustments. For one thing, we in the United States are not prepared for a really large improvement in our trade balance. Our financial markets remain dependent on the large capital inflows from abroad that are a necessary counterpart of our trade and current account deficits. Moreover, taken by itself, depreciation of our currency in an effort to redress the trade deficit poses a risk of renewed inflation.

Only as our huge federal deficit is cut can we comfortably contemplate less borrowing abroad and provide assurance against renewed inflation. Put another way, in a growing economy, reductions in the federal deficit will be necessary to release the real and financial resources necessary to improve our trading position in a way consistent with rising investment.

In a few foreign countries, such as Germany, some signs of stronger internal growth have appeared in recent months. But such signs are far from uniform among key countries abroad, and most projections of their growth for this year have been lowered, not raised, as exports have slowed.

With rising currencies and falling oil prices, some of those countries after years of effort have now successfully achieved virtual stability in consumer prices. Moreover, their wholesale prices have declined sharply and are appreciably lower than a year ago.

All of us—and certainly this central banker—can appreciate the importance of maintaining a broad framework of stability and appropriate financial disciplines to sustain that progress. What is at issue for some countries is their ability to achieve and maintain vigorous internal growth at a time of high unemployment and ample resources as external stimulus fades away, as it must if international equilibrium is to be restored. The appreciation of their currencies and the strong deflationary influences of low oil and other commodity prices would appear to offer a prime opportunity for reconciling those goals of domestic growth and stability.

The International Debt Problem

Four years after the international debt problem broke into our collective consciousness in 1982, when Mexico abruptly lost access to international credit markets, that threat to our mutual prosperity remains. The renewed difficulties of the oil producing countries today should not, however, obscure the progress that has been made. Collectively, the heavily indebted countries of Latin America and elsewhere have made an enormous effort to adjust their external accounts; in fact, in 1984 and 1985, they were in rough current

account balance, in contrast to an aggregate deficit of about $50 billion in 1982.

To be sure, that effort for a time was accompanied by sharply lower imports, recession, and lower standards of living as they brought their spending more in line with their internal resources. But it is also true that many of those countries are again growing, in some cases with vigor, as is the case with the largest single debtor, Brazil. Helped by the reduction in world interest rates, external interest burdens have been reduced appreciably in some countries relative to exports or other measures of capacity to pay. A number of Latin American countries have also made striking progress in dealing with ingrained inflation for the first time in many years, in the process gaining political support. There has been considerable, if uneven, progress toward liberalizing their economic structures in ways that should encourage more growth and productivity over time.

In the midst of this progress, the sharp decline in oil prices over the past six months has had an enormous adverse impact on the oil-exporting heavily indebted countries—Venezuela, Nigeria, Ecuador and Mexico. At current oil prices, for instance, Mexico would lose about a third of its 1985 exports, perhaps as much as 15 percent of its government revenues, and the equivalent of some 5 percent of its GNP. Inevitably, that situation poses a new and severe challenge for Mexico—a challenge that will require strong new efforts to make the necessary economic adjustments and to improve the structure of their economy. There is no large cushion of external reserves to buffer the shock. Consequently, a large amount of financial resources will have to be marshalled from abroad to help ease the transition, to maintain continuity in debt service, and to provide a solid base for renewed growth.

That combination of adjustment, structural change, and appropriate financing is, indeed, the essence of the approach announced by the Mexican government earlier this week. In cooperation with the IMF and the World Bank, Mexico is undertaking a wide range of efforts to deal with both its short- and longer-range economic problems. To my mind, their efforts, in the midst of crisis, to move toward a more open, competitive economy, are particularly encouraging. They have joined GATT, import restrictions are being rationalized and liberalized, a good many state-owned enterprises are being made available for sale (or, if too inefficient, shut down), subsidies are being reduced and eliminated, and procedures for approving foreign investment eased. If carried through effectively, those measures promise to work toward fundamental improvement in the efficiency, competitiveness, and creditworthiness of the Mexican economy, thereby enhancing prospects for longer-term growth.

Today, that country is in recession. But the program clearly contemplates economic recovery in 1987 and 1988. Certainly, sizable amounts of financing from abroad will be required to support that effort. About half of that can be committed by the IMF, the World Bank, and the Inter-American Development Bank. But Mexico is calling upon commercial banks, with so much already at stake, to play a large role as well.

In assessing that situation, I would note that the Mexican exposure of commercial banks appears not to have increased for some 18 months. Indeed, there has been little net new lending to Latin America as a whole over the past year.

Taking the entire period since mid-1982, the exposure of American banks to the heavily indebted countries of Latin America relative to their capital has declined appreciably. That ratio fell from about 120 percent of the capital of lend-

ing banks to less than 75 percent at the end of last year, a decline of 38 percent. No doubt, there has been a further reduction by now.

Those exposures, in relative terms, are actually considerably less than in 1977 when the data were first collected. For some time, the pace of lending has, in fact, been well below that contemplated by Secretary Baker when he set out a framework for a growth-oriented approach toward the international debt problem at the IMF meetings last autumn.

That initiative—essentially contemplating a combination of strong adjustment efforts and structural reform by the indebted countries with reasonably assured financing by international institutions and private banks—is now being tested. It is being tested in difficult circumstances not foreseen at the time—the sharp break in oil prices. But the basic community of interests among borrowers and lenders—and the world at large—in a coherent, cooperative approach is as strong as ever.

The debtor countries themselves have an enormous stake in maintaining their creditworthiness and in seeking solutions in the framework of open, competitive markets. We all have a strong interest in international financial order—all the more when there are other points of strain in the banking system. And, of course, relationships beyond the purely economic are at stake, for the United States most of all.

The challenge is large, but with cooperation, also manageable. Indeed, the same oil price decline that has undermined the budgetary and trading position of Mexico and other large oil exporters has relieved the pressure on those importing oil. Interest rates have declined. A number of borrowing countries will require significantly less, rather than more, financing than was contemplated a year ago. Given the enormous progress made in adjusting external positions, most of the borrowers can look toward more balanced expansion in their imports and exports as they grow—among other things, providing renewed opportunities for American exporters.

But I must also emphasize one essential ingredient for success beyond the capacity of the indebted countries to manage. Only a stable, growing world economy, with markets open to the developing world, can provide an environment conducive to economic expansion, more normal interest rates, and orderly debt service by the borrowers. That ingredient is plainly the responsibility of the industrialized world alone. It is one of the reasons why we must collectively deal with the obvious imbalances among us.

Monetary Policy in 1986

These larger issues were the background against which the Federal Reserve has conducted monetary policy in 1986 and reviewed its objectives for growth in money and credit this year and next. The results of the review by the Federal Open Market Committee of target ranges for money and credit for 1986 and tentative ranges for 1987 were discussed in the Humphrey-Hawkins Report published and sent to the Committee at the end of last week. That report also sets out projections for real activity and prices of FOMC members and Reserve Bank presidents.

As indicated in the Report, the posture of monetary policy remained broadly accommodative over the past six months. The discount rate has been reduced in three steps this year by 1½ percent, in part responding to and in part facilitating declines in short-term interest rates of similar magnitude. Long-term interest rates also moved lower, extending the sharper drops in the second half of last year. The general structure of interest rates is now as low as at any time since 1977.

The reductions in interest rates in 1985 and 1986 have clearly helped support the more interest-sensitive sectors of the economy, reflected in part in the highest level of housing starts since the late 1970s. The declines have also helped ease

the debt servicing costs of businesses, farmers, developing countries and the U.S. Government itself.

On the other side of the ledger, as interest rates have declined, the rate of growth in debt has remained at disturbingly high levels, although there are at least faint signs of a slackening in the rate of debt creation after a burst around the turn of the year. The declines in interest rates also clearly helped induce the general public to increase its holdings of its most liquid assets, including demand deposits and NOW accounts included in the narrow measure of the money supply, M1. That reaction was undoubtedly amplified by the fact that interest is paid on NOW accounts, which are now the favored form in which transaction balances are held by individuals. With interest rate spreads currently quite narrow between NOW accounts and other liquid assets, those accounts no doubt have served increasingly as a repository for liquid savings as well as for money held for transactions purposes.

Similarly, there are some indications of a greater willingness of businesses to hold demand deposits at a time of lower interest rates, partly because, with interest rates down, a larger balance is necessary to compensate banks for a given amount of services. To some extent, an environment of more stable prices may also be encouraging larger money holdings.

None of that was predictable with any precision, and the rate of growth in M1, which ran at almost 13 percent over the first half of the year, was far above the FOMC's target range. Action to restrain that growth within the target range—which would have required reducing the provision of reserves and a significant increase in pressures on bank reserve positions—was not deemed desirable in the light of other important considerations.

One of those considerations was that growth in the broader measures of money—M2 and M3—remained well within their respective target ranges of 6-9 percent, ending the second quarter close to their mid-points. That and other evidence suggested that much of the growth of M1 reflected a shifting of the composition of liquid assets rather than excessive, and potentially highly inflationary, money creation. That judgment was, of course, reinforced by the moderate rate of growth for the economy overall, the absence of indications of a strong acceleration as the year progressed, evidence of greater stability in prices of manufactured goods, and declining commodity prices.

In looking ahead, the Committee decided to retain the existing ranges of 6-9 percent for M2 and M3 this year. The range of 3-8 percent set for M1 early in the year was not recalibrated because of the uncertainties as to the behavior of that aggregate at present. Certainly the inflationary potential of excessive money growth remains a matter of concern. But in current circumstances, the Committee decided that the significance of changes in M1 could only be judged in the context of movements in the broader aggregates, and against the background of movements in interest rates and the economy generally. Taking account of those factors, growth in excess of the target established at the start of the year will be acceptable.

In circumstances of greater economic, price, and interest rate stability, more predictable relationships between M1 and the economy may re-emerge over time, although the trend of M1 velocity—the ratio between GNP and M1—will likely be different than earlier in the postwar period. However, a firm conclusion concerning the nature and stability of future velocity characteristics may take years of experience in the new institutional and economic setting. For the time being, in looking to next year, the Committee set out a highly tentative range of M1 growth of 3-8 percent on the assumption that velocity changes will be within the range of most postwar experience. However, that judgment—and indeed

the weight to be given any M1 range for 1987—will be carefully reviewed at the start of next year.

The tentative 1987 ranges for M2 and M3 were lowered by one-half percentage point to 5½-8½ percent. That modest reduction, consistent with the long-term objective of achieving a rate of monetary growth compatible with price stability, is judged to be entirely compatible with a somewhat greater rate of economic growth next year, provided that growth is not accompanied by a marked increase in inflationary pressures.

The actual price statistics for some months have, of course, reflected the precipitous drop in the price of oil, and consumer prices have dropped slightly this year. But equally clearly, the price of oil will not continue falling so fast, and at some point could well rise again. More predictably, the large depreciation of the dollar will bring in its wake an increase in import prices of manufactured goods. That impact has been moderated so far by the narrowing of the earlier wide profit margins of many of those exporting to us and by the availability of imports from developing countries, few of which have had any appreciable appreciation of their currencies vis-á-vis the dollar.

The rate of increase in costs of housing and of many services, which account for a large proportion of the economy, has decelerated little if at all in recent years. With demand strong, measured productivity gains limited, and compensation or increases in service occupations continuing to average 4½ percent or more, those areas continue to lend a chronic inflationary bias to the general price level.

Those underlying forces are reflected in the projection of FOMC members and Reserve Bank presidents that the overall inflation rate is likely to be somewhat higher next year. That prospect underscores the need for vigilance in the conduct of monetary policy. We want to assure maintenance of the remarkable progress toward stability as the economy grows more strongly and as a large amount of resources are shifted back to manufacturing industries as our trade balance improves. Without such assurance, there would be no firm basis for expecting the level of interest rates to remain for long at lower levels or to decline further.

In looking toward growth in the 3-3½ percent range next year, considerable emphasis was placed by Committee members on the potential contribution to that growth of a stronger trade balance. As I emphasized earlier, that shift, if it is to take place in the context of sustained and stronger world growth, will require appropriately complementary policies here and abroad. Significant progress toward dealing with our own budget deficit seems to me a key ingredient in that overall policy "mix."

The timing of another important domestic policy instrument—discount rate cuts—has been influenced by international financial and exchange rate considerations. A substantial realignment of the excessively strong dollar exchange rate has been a necessary and constructive part of achieving the necessary adjustment in external trade. But there are clear dangers in placing excessive weight on that approach.

History demonstrates all too clearly that a kind of self-reinforcing cascading depreciation of a nation's currency, undermining confidence and carrying values below equilibrium levels, is not in that nation's interest or that of its trading partners. Among other things, such a movement of the dollar now could transmit strong inflationary pressures to the United States and inhibit the free flow of capital from abroad at reasonable interest rates. Moreover, other countries would find it more difficult to sustain their forward momentum.

In the light of all these considerations, the discount rate reductions in March and April were timed to coincide with similar changes by one or more other key countries, minimizing any impact on the exchange markets and consistent with the desirability of some reduction in interest rates in the industrialized world generally.

Some Lessons of Recent Experience

Experience over the first half of 1986 underscored the difficulty—I would say the impossibility—of conducting monetary policy in current circumstances according to one or two simple, pre-set criteria. For instance, the rapid growth of debt and M1 clearly bear watching because of the potential for aggravating the vulnerability of the financial structure to adversity and because of the inflationary potential. However, the weight of the evidence strongly suggests that M1 *alone* during this period of economic and institutional transition is not today a reliable measure of future price pressures (or indeed a good short-term "leading indicator" of business activity). The more restrained performance of the broader aggregates, as well as the performance of the economy and prices themselves, point in a different direction.

At the same time, pressures on the oil industry, agriculture, and parts of manufacturing and the more general disinflationary process are reflected in strains on some depository institutions. Those strains emphasize the importance of dealing with factors more directly under the control of lenders themselves: excessive leveraging of borrowers and loose credit standards. A broad array of approaches by the supervisory and regulatory authorities has been necessary to deal with the particular points of pressure in a manner consistent with the stability of the entire fabric of financial institutions and markets.

The present situation certainly makes all the more pointed the need to provide a stronger sense of legislative direction about the evolution of the financial system over time. There are also urgent specific pieces of legislation before you to permit the FDIC and the Federal Reserve to facilitate interstate acquisitions of failed or failing banks and to supplement the resources of the FSLIC.

The difficulties of some financial institutions are one specific example of economic problems that cannot be effectively dealt with by monetary policy alone. It is indeed a strength of monetary policy that it can respond flexibly to changing circumstances. But it is equally true that that single, broad-brush policy instrument cannot, at one and the same time, be called upon to stimulate the economy, protect the dollar, restrain excessive debt creation, and shift resources away from consumption and back into investment, manufacturing and exports—as desirable and important as all those goals may be.

Events of recent years have also heavily underscored how cumbersome fiscal policy can be, and the difficulties of achieving political consensus on such matters as tax reform and the appropriate legislative framework for financial institutions. On an international scale, achieving consensus on appropriate action can be still more difficult.

We have nonetheless come a long way toward restoring growth and stability in this decade. But my sense is that all that progress is in growing jeopardy unless we act—we in the United States, we in the industrialized world, and we in the world as a whole—in mutually supportive ways.

The main directions of that effort seem to me clear enough. The Gramm-Rudman-Hollings legislation is an expression of the sense of urgency surrounding our budgetary effort in the United States. The rest of the industrial world needs to achieve and maintain a momentum of "home-grown" expansion. With strong national and international leadership—and with the cooperation of private and public lenders—a constructive resolution of the economic crisis in Mexico can point the way to a wider resolution of the debt problem in a context of growth.

Hard as it may be to carry through on those efforts, that is what needs to be done if the imbalances in the economy are to be effectively addressed. Then we will have a really solid base for sustaining the momentum of growth and the progress toward stability in the years ahead. Certainly, the Federal Reserve will play its part in that effort.

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Monetary Policy Objectives for 1986

Summary of Report to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978. July 18, 1986.

Contents

Monetary Policy in 1986 and 1987

Sharp contrasts among sectors and regions of the economy characterized economic developments during the first half of 1986. Because of strong competitive pressures from abroad and large spending cutbacks in the oil industry in response to sharply declining prices, industrial and investment activity were restrained. In contrast, activity continued to expand rather strongly in housing, the financial sector, and the broad service area of the economy.

Although there are substantial uncertainties about the degree and timing of a pickup in overall economic activity, a number of positive economic and financial developments have occurred that should provide the basis for somewhat faster economic growth and some reduction in unemployment over the year ahead. Interest rates have moved lower, and, reflecting the decline of the dollar on foreign exchange markets, U.S. industry is in a stronger competitive position internationally. In addition, inflation has remained subdued, reflecting not only declines in the prices of energy and other basic commodities but also continued restraint on wages in many sectors. Much of the uncertainty about a pickup in growth turns on the strength of economic performance in other industrialized countries, and there also is some concern over the transitional effects of tax reform legislation.

A reduction of the large deficit in the nation's external accounts is of critical importance over time, and this will be difficult to achieve in an orderly way without faster growth in key foreign economies. Agreement on tax reform also would remove a major source of uncertainty that probably has inhibited growth in the first half of the year. In addition, substantial progress toward eliminating federal budget deficits is essential to achieving better balance in the U.S. and world economies. Overall, prospects for the economy appear to be favorable, but much will depend on the evolution of policy, both in this country and abroad.

Growth of Money and Debt in 1986 and 1987

The Federal Open Market Committee (FOMC) reaffirmed the 1986 target ranges of 6 to 9 percent that had been established in February for growth in the broad money measures—M2 and M3.

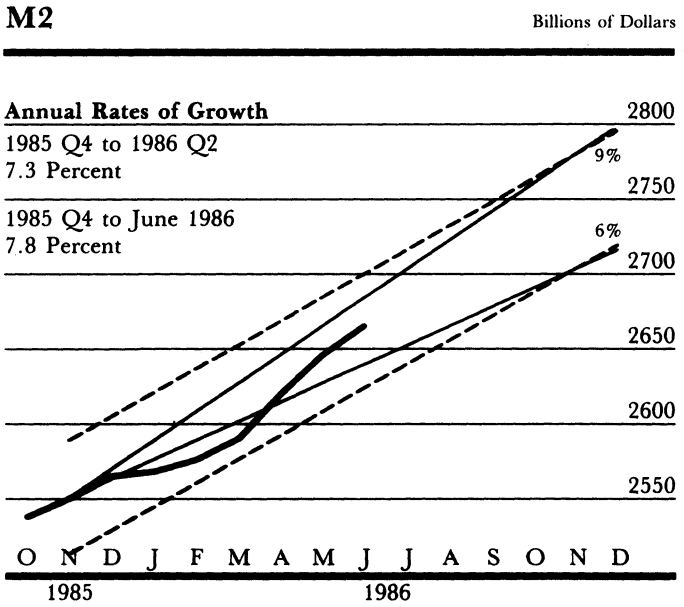
For 1987, the Committee decided that the target growth ranges for both M2 and M3 would be

Ranges of Growth for Monetary and Debt Aggregates[1] (Percent Change)

	1986	Tentative for 1987
	1985 Q4 to 1986 Q4	1986 Q4 to 1987 Q4
M1	(3 to 8)*	(3 to 8)**
M2	6 to 9	5½ to 8½
M3	6 to 9	5½ to 8½
Debt	8 to 11	8 to 11

*While no new range was specified for 1986, growth in excess of the established range would be acceptable.

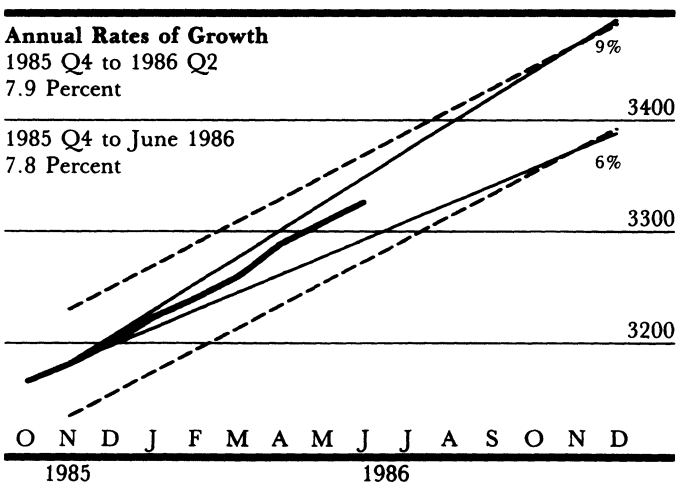
**Indicative of likely range if more stable velocity behavior shows signs of re-emerging.

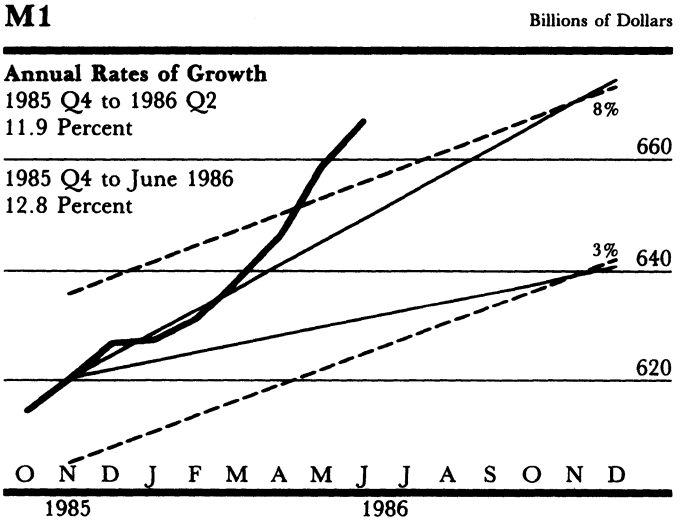


lowered by 1/2 percentage point, to 5½ to 8½ percent, to achieve money growth at a rate consistent with maintaining reasonable price stability and sustainable economic expansion.

The rapid rise in M1 over the first half of the year underscored the degree of uncertainty surrounding the behavior of the aggregate and, in particular, about its behavior relative to GNP. The nature of the relationship among M1, income, and interest rates appears to have been significantly altered by the changed composition of the aggregate in recent years, as well as by the prospects for greater price stability. The Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable and growth in that aggregate over the balance of the year would continue to be evaluated in light of the behavior of the other monetary aggregates.

With respect to 1987, the Committee expressed the preliminary view that the current range for M1—3 to 8 percent—should provide for adequate money growth to support continued economic expansion, assuming that greater stability re-emerges in the link between M1 and income in a more stable economic, price, and interest rate environment.





Economic Projections

As is summarized in the table below, the central-tendency forecast is for growth of 2½ to 3 percent in real GNP this year. Such an increase in output would be expected to generate appreciable further gains in employment, but the unemployment rate might not drop below 7 percent before year-end.

In 1987, which would be the fifth year of the current expansion, real GNP is projected to increase 3 to 3½ percent, and unemployment is expected to decline moderately. A significant portion of the increase in production next year is expected to come from the external sector, with the lower value of the dollar expected to restrain the growth of imports and stimulate exports. However, with energy prices leveling off, exchange-rate-related increases in import prices are expected to cause an acceleration in inflation to the 3 to 4 percent range next year.

Progress in reducing the federal deficit is seen as crucial in maintaining financial conditions conducive to balanced growth and to an improved pattern of international transactions.

A critical element in the expected improvement in economic performance is progress toward reducing the size of the merchandise trade deficit. With import prices rising as a result of the depreciation of the dollar, the growth in imports is expected to slow, and the increased price competitiveness of U.S. goods should bolster export growth. However, a substantial improvement in our trade performance will require satisfactory growth of demand in other countries. Moreover, it will require open access to foreign markets, which underscores the critical importance of avoiding protectionist measures both here and abroad.

Economic Projections for 1986 and 1987

		FOMC Members and other FRB Presidents	
1986		Range	Central Tendency
Percent change, fourth quarter to fourth quarter:	Nominal GNP	3¾ to 6½	4¾ to 5¾
	Real GNP	2¼ to 3½	2½ to 3
	Implicit deflator for GNP	1½ to 3¼	2¼ to 2¾
Average level in the fourth quarter, percent:	Civilian Unemployment Rate	6.9 to 7.2	7
1987		Range	Central Tendency
Percent change, fourth quarter to fourth quarter	Nominal GNP	5 to 8¼	6 to 7½
	Real GNP	2 to 4¼	3 to 3½
	Implicit deflator for GNP	1½ to 4¼	3 to 4
Average level in the fourth quarter, percent:	Civilian Unemployment Rate	6½ to 7	Around 6¾

Economic Performance: First Half 1986

The economy continued to expand in the first half of 1986. Real GNP grew about 2½ percent, at an annual rate, according to preliminary Commerce Department estimates. The overall increase in output during the first six months of the year generated slightly more than one million new jobs, and the civilian unemployment rate held near 7 percent. At the same time, the dramatic decline in world crude oil prices caused a substantial slowing in inflation.

The combination of the lingering effects of the high foreign exchange value of the dollar during 1984 and 1985, the slow growth abroad, and the initial impact of lower crude oil prices played a key role in inhibiting any acceleration in overall economic activity. Industrial output declined noticeably over the first half, with activity reflecting the continuing intense competition from foreign producers in the manufacturing sector and also the sharp cutbacks in energy-related investment. U.S. agriculture confronts growing world supplies of many farm products, and many farmers continue to be squeezed by a heavy debt-servicing burden and falling land values. The drop in oil prices also has caused substantial adjustment problems.

However, some of the benefits from the drop in oil prices did begin to emerge in the first half. The lower price of crude oil was reflected fairly quickly in the prices of finished energy products, which caused consumer prices to register their largest three-month decline since the beginning of 1949. This lower price level has given a substantial boost to consumers' purchasing power and has helped to support higher levels of spending. Although the volume of oil imports will rise, the sharper decline in price is an aid in reducing the large deficit in our trade accounts.

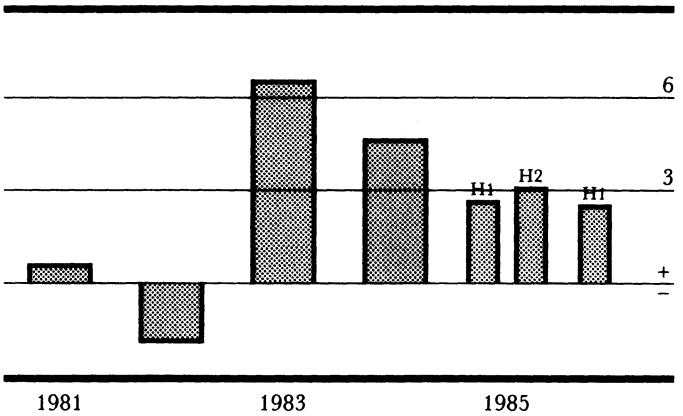
A potentially more significant longer-term influence on our balance of trade is the lower value of the dollar. The prices of foreign goods are rising in dollar terms and should begin to shift expenditures from imports to domestic products. At the same time, U.S. goods are more competitive on world markets, although we have yet to experience a sustained improvement in exports.

The prospect of lower federal budget deficits in the years ahead, coupled with the drop in oil prices, encouraged sizable reductions in long-term interest rates at the beginning of 1986, which have begun to stimulate the interest-sensitive sectors of the economy. The most notable result has been in the housing sector where lower mortgage rates have led to substantial gains in building activity. Investment in new plant and equipment has not shown a similarly positive response to the lower interest rates. Apart from the negative effects of the oil drilling decline, business spending has been damped by the existence of a sizable overhang of office and factory space and by continuing uncertainties about sales trends and tax reform.

With the decline in energy prices, further progress has been made in reducing the inflation rate. Continued moderation in wage increases and abundant supplies of agricultural commodities and industrial raw materials also were important factors in restraining price increases in the first half of 1986. These favorable developments worked to offset the inflationary tendencies associated with the depreciation of the dollar and the continued rapid rise in the prices of services.

Real GNP

Percent change from end of previous period, annual rate



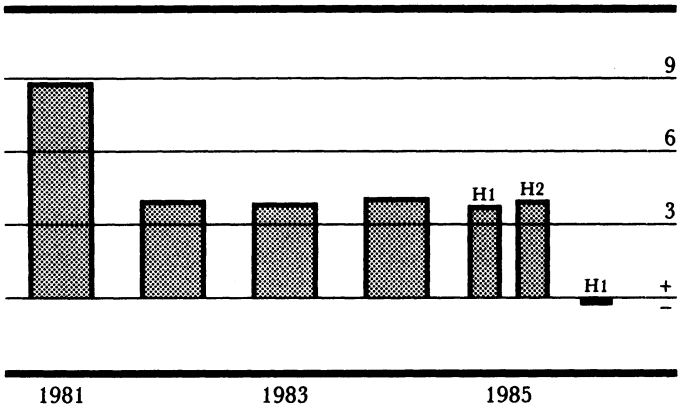
Price Developments

Falling energy prices were largely responsible for a significant slowing in measures of aggregate inflation during the first half of 1986. A broad measure of prices—the GNP fixed-weighted price index—increased at a 2¼ percent annual rate in the first half, down from a 3½ percent rise in 1985. Consumer prices actually declined over the February to April period, but they still were up 1¾ percent over the twelve-months ended in June. The drop in prices was greater at the wholesale level, where weakness in the industrial sector added to the downward pressure from energy prices.

Outside of the energy area, further progress was made in reducing the inflation rate during the first half of the year. Retail food prices rose at only a 1 percent annual pace through June, held down by falling meat prices. A small decline in the prices of consumer goods was responsible for the slowdown in the CPI excluding food and energy to a 3½ percent annual rate of increase from its 4½ percent rise during 1985. In contrast, the prices of nonenergy services continued to increase at a 6 percent annual rate, boosted by rising housing costs and by higher premiums for most types of insurance.

Consumer Prices*

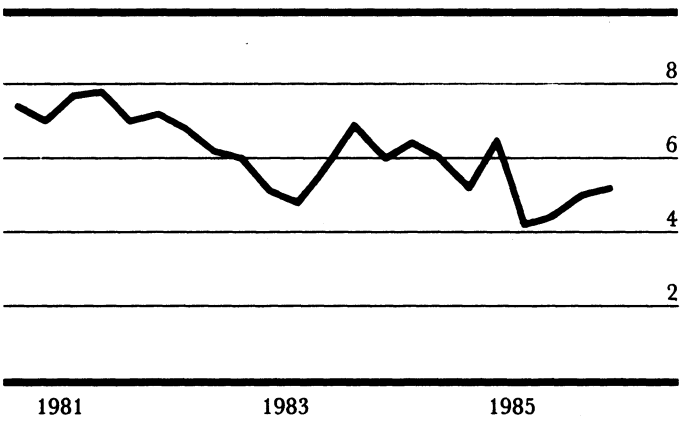
Percent change from end of previous period, annual rate



*Consumer Price Index for all urban consumers.

Personal Saving Rate

Percent of disposable income



The Household Sector

Consumer expenditures were quite strong in the first half of 1986, supported in part by rapid income growth. Real disposable personal income increased at about a 7 percent annual rate, boosted by high levels of farm subsidy payments and the energy-related slowdown in inflation.

The increase in consumer spending was widespread. Purchases of nondurable goods, such as apparel, were particularly strong in the first quarter, while outlays for services also grew briskly. The demand for new automobiles also remained quite high after the large sales increase in 1985.

Indicators of the financial position of the household sector were mixed in the first half of the year. Although the growth in consumer credit slowed from its rapid growth pace in 1985, the ratio of consumer installment debt to disposable income edged up to a new high. The rallies in the stock and bond markets strengthened the asset side of the household sector balance sheet. Many homeowners took the opportunity presented by the decline in interest rates to ease their debt-servicing burdens by refinancing mortgage loans. However, increased strains also were evident, as personal bankruptcies rose to record levels and mortgage delinquency rates remained historically high.

The Business Sector

The financial position of the business sector improved during the first half of 1986, albeit with considerable diversity across industries. Economic profits in the corporate sector rose at an $11 billion annual rate in the first quarter. Financial conditions in agriculture and manufacturing remained weak, however. Agriculture continued to be hurt by excess supply conditions worldwide, and farm loan delinquencies rose to a postwar high. In manufacturing, intense price competition from foreign sources squeezed profit margins, and with little growth in demand, capacity utilization moved lower.

Business spending on plant and equipment was weak in the first half of the year. This poor performance partly reflected a "payback" after very strong capital spending in the fourth quarter of 1985. Firms apparently accelerated their spending at the end of last year to take advantage of investment incentives that were targeted for scaling back or elimination under proposed tax reform legislation; expenditures then dropped off in the first quarter of 1986.

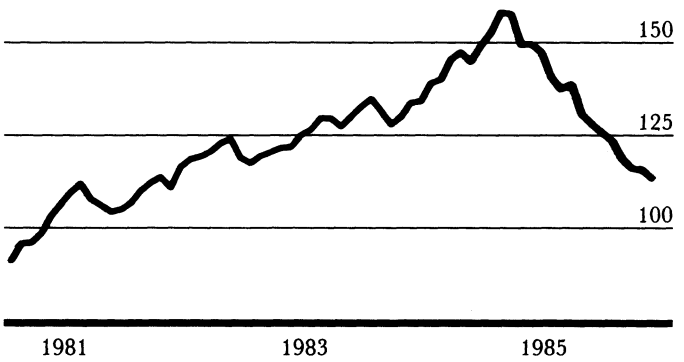
Much of the change in business inventories in the first half of this year was associated with fluctuations in automobile dealers' stocks. Domestic car production outpaced sales in the first quarter, and this resulted in a substantial build-up of auto inventories. Manufacturers continued to trim their stocks, preferring to keep inventories lean until there was firm evidence of a resurgence in demand.

The Foreign Sector

The dollar depreciated further against the currencies of foreign industrial countries during the first half of 1986. On balance, the trade-weighted value of the dollar has fallen over 30 percent from its February 1985 peak, about one-third of which has occurred this year. Associated with the depreciation was a narrowing in inflation-adjusted interest rate differentials between the United States and the other major industrialized countries, as interest rates declined both here and abroad.

Exchange Value of the U.S. Dollar*

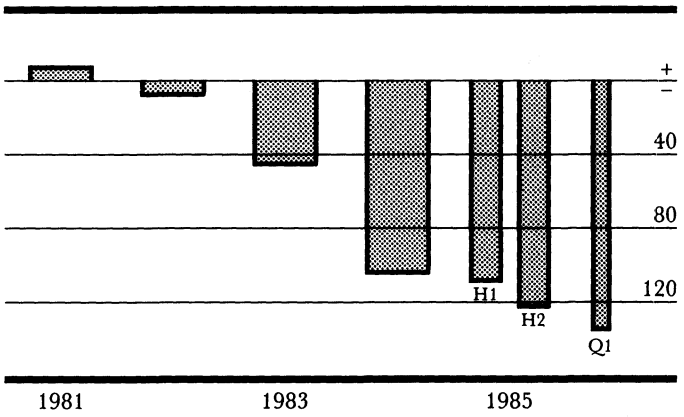
Index, March 1971 = 100



*Federal Reserve index of weighted average exchange value of U.S. dollar against currencies of other G-10 countries plus Switzerland. Weights are 1972–76 global trade of each of the 10 countries.

U.S. Current Account

Annual rate, billions of dollars

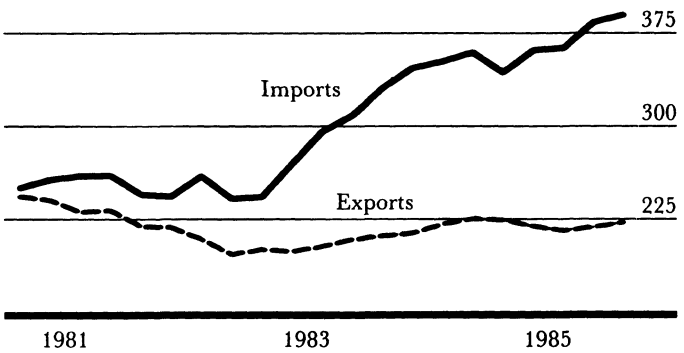


Although a substantial correction has occurred in the dollar's value, at least against the currencies of the major industrialized countries, the nation's current account deficit was unchanged in the first quarter from the high $135 billion rate of the fourth quarter of 1985. This lack of improvement was the result of large increases in nonpetroleum imports while exports grew more slowly.

Yet, the decline in the dollar improved the price competitiveness of U.S. goods in foreign markets.

U.S. Real Merchandise Trade

Billions of 1982 dollars



However, exports have been slow to pick up, in important part, because of the sluggish pace of foreign economic activity.

The volume of U.S. merchandise imports rose 1½ percent in the first quarter of 1986. The largest increases were in machinery, with smaller advances registered for some consumer goods. The volume of merchandise exports was up somewhat in the first quarter, with a 3½ percent decline in exports of agricultural products offset by increased U.S. nonagricultural exports.

Money, Credit, and Monetary Policy

The Committee emphasized that policy implementation would involve a continuing appraisal of trends in all of the money and credit measures, as well as of indicators of economic activity and prices, and conditions in credit and foreign exchange markets. Within this framework for policy, the Federal Reserve basically accommodated the demands for reserves associated with strong M1 growth over the first half of 1986.

In the initial months of 1986, growth of M1 dropped off sharply from its rapid 1985 pace, and growth of M2 also slowed substantially, to a rate below its annual target range. There were signs of some sluggishness in economic activity, and steep declines in oil prices, which were improving the outlook for inflation, contributed importantly to a rally in long-term credit markets that picked up momentum in mid-February. At the same time, short-term interest rates edged a little lower, but the federal funds rate remained significantly above the Federal Reserve's discount rate.

In this context, a cut in the discount rate would complement the thrust of open-market operations and would accommodate the market tendency toward lower interest rates. However, an important consideration in the timing and extent of any rate cut was the risk posed by an excessive reaction in the foreign exchange markets, where the dollar remained under downward pressure during much of the period.

On March 7, the Federal Reserve cut the interest rate charged for discount window borrowings by 1/2 percentage point to 7 percent. The central banks of Japan, Germany and several other industrial nations took similar actions around the same time.

On April 18, the Federal Reserve announced another reduction in the discount rate, to 6½ percent. This change served primarily to catch up with and validate declines that already had taken place in market rates. Exchange rates and international interest rate considerations again played a role, and our discount rate cut coincided with a rate cut by the Bank of Japan.

With market interest rates falling, price pressures remaining subdued, and the economies of the United States and other industrial countries growing relatively slowly, the Federal Reserve again reduced

Growth of Money and Credit (Percentage changes at annual rates)

Period		M1	M2	M3	Domestic Nonfinancial Debt
Fourth quarter 1985 to second quarter 1986		11.9	7.3	7.9	13.0[e]
Fourth quarter 1985 to June 1986		12.8	7.8	7.8	12.7[e]
Fourth quarter to fourth quarter	1979	7.5	8.1	10.3	12.3
	1980	7.3	9.0	9.6	9.6
	1981	5.2 (2.5)[1]	9.3	12.3	9.8
	1982	8.7	9.1	10.0	9.0
	1983	10.4	12.2	9.9	11.2
	1984	5.4	8.0	10.5	14.3
	1985	11.9	8.6	7.6	14.0
Quarterly average 1985	Q1	10.1	11.7	10.2	13.6
	Q2	10.5	6.3	5.5	12.0
	Q3	14.5	9.5	7.6	12.9
	Q4	10.7	6.0	6.5	14.6
Quarterly average 1986	Q1	7.7	4.3	7.4	16.1
	Q2	15.8	10.3	8.3	9.6[c]

e—estimated

1. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

the discount rate by 1/2 percentage point, to 6 percent on July 11.

On balance, since the end of 1985 the dollar has declined more than 10 percent, and short-term rates about 1½ percentage points. Long-term Treasury yields fell 2 percentage points, but yields on other long-term securities fell less; corporate and tax-exempt bond yields dropped about one point, and fixed-rate mortgages fell just 1/2 percentage point.

In contrast to M1, which grew at a 12¾ percent annual rate through June, both M2 and M3 grew moderately in the first half of the year and in June were near the middle of their respective ranges. Some of the more liquid components of the broader monetary aggregates, however, increased very rapidly, as part of the larger shift in investor portfolios toward short-term assets. This shift had much less effect on M2 or M3 than on M1, because the reallocation of funds took place largely within these broader aggregates. In addition to transaction deposits, money market deposit accounts, money market mutual funds, and ordinary savings deposits all expanded strongly during the first half of the year, but small time deposits grew only slightly.

The debt of domestic nonfinancial sectors is estimated to have expanded at a more moderate rate over the first six months of 1986 than it had in some time. Bond issuance had surged in December in advance of the possible effective date of some provisions of tax-reform legislation, lifting the first-quarter level of the debt aggregate. Hence, when measured from its fourth-quarter-average base, the growth of domestic nonfinancial sector debt has remained above its monitoring range, coming in at a 12¾ percent annual rate through June. Measured from its level at the end of December, however, debt grew at an annual rate of 10¼ percent through the end of June.

The stresses evident in many parts of the economy left their mark on the books of banks and of other financial institutions. Asset quality deteriorated as a consequence of the sharp drop in oil prices and associated dislocations in the energy sector, overbuilding in commercial real estate, and the continuing distress in agriculture. Banks with relatively large amounts of farm loans outstanding, as well as other agricultural lenders, have been particularly hard hit recently; loan losses at these institutions have soared and their profitability has continued to slide. While banks in regions with economies heavily dependent on energy production were among the most strongly capitalized and profitable earlier, their financial position has eroded under the pressure of surrounding economic difficulties. Bank failures in the first half of this year continued to run at about 1985's rapid pace, with agricultural banks again accounting for a disproportionate share.

At savings and loan associations, overall profitability appears to be improving as interest rates have declined and mortgage origination activity has surged. However, a substantial number of these institutions continue to have severe problems owing primarily to losses on weak assets, prompting proposals to add to the financial resources of the FSLIC.

Concern over loans to certain developing countries came to the forefront again this year as Mexico began to grapple with the additional economic and financial problems brought on in large part by dramatically lower oil prices. Banks have remained cautious lenders in the face of ongoing concerns about the economic and financial prospects of these countries.

Footnotes

1. **M1** is currency held by the public, plus travelers' checks, plus demand deposits, plus other checkable deposits (including negotiable order of withdrawal (NOW and Super NOW) accounts, automatic transfer service (ATS) accounts, and credit union share draft accounts).

M2 is M1 plus savings and small denomination time deposits, plus Money Market Deposit Accounts, plus shares in money market mutual funds (other than those restricted to institutional investors), plus overnight repurchase agreements and certain overnight Eurodollar deposits.

M3 is M2 plus large time deposits, plus large denomination term repurchase agreements, plus shares in money market mutual funds restricted to institutional investors and certain term Eurodollar deposits.

A copy of the full report to Congress is available from Publication Services, Federal Reserve Board, Washington, D.C. 20551

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