Monetary Policy Objectives for 1987

Midyear Review of the
Federal Reserve Board
July 21, 1987

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

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Chairman, Federal Reserve Board

I appreciate this, my last, opportunity to appear before you as Chairman of the Federal Reserve Board in connection with the semi-annual review of monetary policy. You have the official Report of the Board of Governors before you and I will be blessedly brief in touching upon some of the main points.

As you know, the economy has continued to grow this year, carrying the expansion well into its fifth year. At the same time, however, the inflation rate has accelerated appreciably relative to the low rate prevailing in 1986.

A change in that direction had been widely anticipated in response to the rebound in oil prices and the depreciation of the dollar. Nevertheless, the size and pervasiveness of the price increases—which have included many non-energy materials as well as services—affected the psychology and expectations in financial markets, particularly in April and early May. Recurrent concerns about the dollar internationally also at times affected the mood of domestic markets, and interest rates rose rather sharply for a time.

Through the early part of the year, Federal Reserve operations placed minimal pressure on bank reserve positions. As reported earlier, however, beginning in late April definite but modest steps were taken to increase reserve pressures somewhat. Perceptions of that action appeared to help calm concerns about the future course of the dollar and inflation.

Most interest rates, long- and short-term, have retraced part of the earlier rise. However, long-term interest rates and prices of sensitive commodities, some of which had been deeply depressed, remain well above their levels of earlier this year.

The approach of the Federal Reserve toward the provision of reserves has not changed since May. However, growth in the various monetary aggregates slowed further in the second quarter. A reduction in the rate of growth of those aggregates from the relatively high levels of 1986 had been both anticipated and desired by the Federal Open Market Committee, as reported to you in February. However, it is also true that, with institutional and market developments importantly affecting the relationships between the various measures of money and the variables we ultimately care about, judgments about the appropriate growth of the aggregates have become both more difficult and more dependent on prevailing economic and market circumstances.

For that reason, the Committee did not set forth a particular target range for M1 this year in February. That judgment was reaffirmed at the meeting earlier this month. M2 is currently running below, and M3 around, the lower ends of their 5½ to 8½ percent ranges established in February. The Committee decided not to change those ranges for 1987. In doing so, however, there was agreement that, depending on further evidence with respect to emerging trends in economic activity, inflation, and domestic and international financial markets, actual growth around the lower ends of those ranges may well remain appropriate.

In judging appropriate monetary growth during the course of the year, or from year to year, account needs to be taken of the apparent increase in the sensitivity of demands for money, and for money-like assets, to absolute and relative changes in market interest rates. Interest rates administered by institutions, especially those on transactions accounts, tend to lag market rates

both when interest rates are rising and when they are falling (of course, no explicit interest can be paid on demand deposits). At the same time, the cost and effort involved in shifting funds between types of accounts, or into and out of market instruments, has greatly diminished. Experience suggests that, as a result of these factors, demand deposits, NOW accounts, and money market deposit accounts all tend to grow relatively slowly, if at all, when market rates are rising (as during the second quarter) but much faster than normally as market rates fall, as during 1985 and 1986. Those differences in growth rates in money will tend to be reflected in inverse movements in the velocity (that is, the measured rate of turnover) of money rather than commensurate changes in economic activity or prices.

That sensitivity of velocity to changes in interest rates makes it more difficult to judge the appropriate rate of monetary growth—particularly over periods as short as a quarter or a year—and impossible without reference to the stream of available evidence on economic activity, prices, and other factors. This year, too, concerns about the international performance of the dollar have at times had a significant bearing on operational decisions. Specifically, the tightening of reserve availability in the spring was related in substantial part to the desirability, in the light of the substantial cumulative depreciation over the previous two years and other economic policy undertakings here and abroad, of maintaining reasonable stability in the external value of the dollar. That judgment is, as you know, shared with the Administration and the finance ministers and central bank governors of other leading industrialized countries.

Looking ahead to 1988, the Open Market Committee decided tentatively to reduce the target ranges for M2 and M3 by 1/2 percent to 5–8 percent. While recognizing the inevitable range of uncertainty I referred to earlier, some reduction in the target ranges clearly appeared appropriate in recognition of the importance of assuring that the temporary bulge in price increases foreseen for this year not become a base for a renewed inflationary process. The appropriate range for 1988 will, of course, again be reviewed with care at the start of the year.

More broadly, policy has to be judged against progress toward the more basic goals of growth and stability—and it seems to me fatuous to think the first could long be sustained without the latter. At the same time, now and for some years ahead, we will need to work to narrow and ultimately correct the large imbalances in our internal and external economic positions—adjustments that necessarily have implications for the policies and prospects of other countries as well. What is at issue is whether we can make those necessary adjustments while sustaining progress toward the broader goals.

In some areas, developments in the past six months have been strongly encouraging in that respect.

- The evidence by now is pretty clear that, in real terms, our trade balance is improving, even in the face of continuing sluggish growth, high unemployment and excess capacity abroad.
- While growth in domestic consumption has slowed—one essential part of the adjustment process—the expansion of domestic output and employment has been well maintained, and unemployment, at close to 6 percent, has dropped to the lowest level in this decade. Manufacturing has picked up and prospects for business investment may be improving.
- Helped by some large unanticipated capital gains tax receipts, this year's budget deficit will apparently be driven even below earlier expectations, and thus very substantially below the fiscal 1986 level.
- Internationally, leading nations are not only agreed upon the desirability of greater exchange rate stability but appear to be working more effectively to that end.

- In another area demanding a high level of international cooperation, the basic approach for dealing with the international debt problems has continued to be implemented with substantial success despite doubts and challenges by some.

Of central importance, there has been continuing evidence of restraint and discipline on costs and wages in much of American industry, offering the prospect of lower rates of inflation in the months ahead. Over time, that must be an absolutely essential element in maintaining our international competitivness as well as in restoring domestic stability after the bulge in prices this year.

At the same time, it would be nonsense for me to claim that all is safely and securely on path. The remaining risks and problems are apparent. Even the otherwise satisfying fall in the unemployment rate this year implicitly has a discouraging aspect. Outside of manufacturing, the statistics suggest productivity growth is quite dismal—so slow, in fact, that I cannot dismiss the thought that the reported statistics may partly reflect measurement error.

But no error of measurement can entirely explain away that our private saving, in historical or in international context, remains so low, or that our federal deficit remains so large, or that we, the putative leader of the western world, are so dependent on other people's capital. Despite the better news on this year's federal deficit, some projections of future deficits *assuming current programs* are being raised rather than reduced and the political impasse over doing something about it apparently remains. In the circumstances, the Gramm-Rudman-Hollings targets are threatening to become pie in the sky.

The already slow growth in other industrialized countries appears to have slowed further this year, working against the adjustments needed in trade and current account positions among Japan, Western Europe and the United States. And, in that environment the dangers of protectionist trade legislation and a breakdown in the servicing of international debts are enlarged. For all those reasons and more, my very able successor, and the Federal Reserve generally, will have challenge aplenty. But, I, as I have spelled out earlier, would like to think there is something upon which to build as well.

Finally, Mr. Chairman, I would like to acknowledge specifically the usefulness from my standpoint of these regular semi-annual hearings on monetary policy.

You and I are both conscious of the special position of the Federal Reserve System within the overall framework of government. The long terms of members of the Board of Governors, the participation of the Regional Federal Reserve Banks in the policy process, our budgetary autonomy, and the professionalism of our staff are all designed to provide some insulation, in deciding upon money creation, against partisan or passing political pressures.

In our system of government, however, insulation cannot be equated to isolation, and particularly isolation from reporting and accountability to the Congress and to the public. These hearings are an important element in that discipline. I have welcomed the opportunity they have provided for us to consult with the Congress, and to explain our purposes, our approaches, and our problems in dealing with a complicated, changing economic environment. And I want to express my appreciation as well for the many courtesies you have extended me personally over these past eight years as we have worked together to foster economic stability and growth.

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Monetary Policy Objectives for 1987

Summary of Report to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978. July 21, 1987.

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Monetary Policy and the Economic Outlook for 1987 and 1988

The economy expanded at a somewhat accelerated pace in the first half of 1987, and the civilian unemployment rate declined over the period to 6.1 percent in June, the lowest level in this decade. Moreover, the pattern of activity has exhibited encouraging signs that a turnaround in the trade sector is under way. An improvement in net exports, in real terms, appears to be providing a lift to activity in the industrial sector, offsetting slower growth of domestic spending and sustaining a moderate rise in overall domestic production. However, the process of restoring balance to the U.S. external accounts has involved a sizable increase in the prices paid for imported goods. These price increases have occurred at the same time that a rebound in world oil prices carried inflation rates above last year's modest pace.

Although some of the elements necessary for sustaining economic growth are now beginning to fall into place, the economic outlook continues to be clouded by a number of imbalances, risks, and uncertainties. The experience of the first half of 1987 underscored, in particular, the dangers associated with a loss of market confidence in the dollar and the related potential for a rekindling of inflation expectations. The Federal Reserve, in implementing monetary policy, was sensitive to these dangers, while it continued to provide support for sustainable economic growth. During the first part of the year, growth in money and credit slowed from the rapid pace of 1986, even though pressures on the reserve positions of depository institutions remained mild. Those pressures were increased somewhat in late April and May, however, as the dollar fell sharply against other key currencies, inflation expectations flared up, and long-term interest rates jumped to higher levels. In response to these steps, and to complementary policy actions taken abroad, the dollar has stabilized, and interest rates have retreated somewhat from their May highs.

If the nation is to achieve an orderly transition to better external balance, one marked by a minimum of financial or inflationary pressures, responsible action by many parties—in addition to the Federal Reserve—will be necessary. Further progress in reducing our federal budget deficit is essential: a failure to achieve this often-stated objective could only damage confidence in our ability to deal with our economic problems and contribute to imbalances in financial markets and the economy. In addition, satisfactory growth in the other major industrialized countries is crucial, as are efforts on all sides to maintain and improve the openness of the international marketplace. The private sector also must play a constructive role, by remaining sensitive to wage and price practices that promote the international competitiveness of American business.

Economic and Financial Background

The economic expansion has now progressed well into its fifth year. Real GNP rose at a 4¾ percent annual rate in the first quarter. However, much of the increase in production reflected a rebuilding of business inventories that had been drawn down late in 1986, and real GNP appears to have increased at an appreciably more moderate pace in the second quarter. Nonetheless, growth remained strong enough to sustain a downtrend in unemployment.

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

	1987	Tentative for 1988
	1986 Q4 to 1987 Q4	1987 Q4 to 1988 Q4
M2	5½ to 8½	5 to 8
M3	5½ to 8½	5 to 8
Debt	8 to 11	7½ to 10½

Beneath these solid gains in aggregate economic activity have been welcome improvements in the fortunes of sectors that have failed to participate in the increasing prosperity of the past several years. As suggested above, the most significant development has been the emerging improvement in the nation's trade performance, which has begun to close the gap between the pace of growth in the industrial sector and the rest of the economy. Indeed, some segments of manufacturing have reached relatively high levels of capacity utilization and strong profitability. Economic strains also appear to be easing in other troubled sectors. Oil-well drilling, while still at depressed levels, has turned up as a consequence of the firming of world oil prices. Agricultural income was quite high last year, although it continued to be heavily dependent on government support. Farmland values seem to have stabilized, and the amount of delinquent farm loans has begun to decline.

While the external sector has been strengthening, in real terms, in recent quarters, growth in domestic demand has moderated considerably. To some extent, the slower rise in household and business purchases in the early months of this year was a reflection of the acceleration that had occurred at the end of 1986, motivated by tax considerations. However, consumers, in particular, have shown signs of less exuberance in their expenditure patterns after a period of several years in which their willingness to spend increasing proportions of their income provided considerable thrust to business activity. A moderation of domestic spending growth is, of course, a fundamental ingredient in achieving better external balance without putting excessive strains on available resources.

A key element in the recent trade developments has been the steep drop in the foreign exchange value of the dollar—almost 40 percent on a trade-weighted basis against other G-10 currencies—since early 1985. That decline, in conjunction with notable restraint on labor costs, has greatly enhanced the competitiveness of U.S. producers in international markets. At the same time, though, the depreciation has caused prices of imported goods to increase—sharply in some cases—and exacerbated a bulge in prices coming from higher energy costs. The rise in consumer prices, averaging more than 5 percent at an annual rate over the first five months of this year, was a disturbing departure from recent experience. Moreover, as the dollar exhibited continued weakness in the early spring, and with progress toward improvement in the U.S. current account slower than many had anticipated, concerns mounted about inflation prospects. This was reflected for a time in rising prices of precious metals and other actively traded commodities, an event that only served to reinforce the inflation fears that simultaneously were unsettling U.S. securities markets.

In these circumstances, and with the economic advance evidencing reasonable momentum, the Federal Reserve in late April and May adjusted its open market operations to impose a somewhat greater, but still quite limited, degree of pressure on the reserve positions of depository institutions. This step was reassuring to the markets. Coupled with complementary actions by monetary authorities abroad and more favorable news on prices and U.S. merchandise trade flows, the firming of money market conditions contributed not only to a turnaround in the dollar on exchange markets but also to a rally in bond prices. On balance, however, short-term interest rates currently are about one-half percentage point above their levels at the time of the Board's February monetary policy report to the Congress, and long-term rates are up about a full percentage point.

The rate of growth of the money stock measures, M2 and M3, has been well below that of last year and close to, or below, the lower end of the target ranges adopted in February. This has been viewed as acceptable by the Federal Open Market Committee (FOMC), given the inflation and exchange rate developments, as well as indications of greater than anticipated strength in the velocity of money (that is, the ratio of nominal GNP to money). M2 rose at an annual rate of only 4 percent between the fourth quarter and June, appreciably below the 5½ to 8½ percent growth range for the year. M3 grew at a 5¼ percent rate, a shade below the lower bound of its identical range.

The marked deceleration of monetary growth, and the accompanying rise in M2 and M3 velocity after two years of decline, reflected a variety of influences. Some unwinding of the buildup in balances that occurred late last year in connection with a huge volume of tax-related transactions may have been involved; tax reform also may have damped growth in money as individuals reduced their additions to deposit holdings rather than using consumer credit, on which interest is no longer fully tax-deductible. Capital constraints on the growth of bank and thrift institution assets may have limited the depositories' efforts to seek funds, an effect likely to express itself most fully at the level of M3, which encompasses a broad range of depository-institution liabilities.

But it is another factor that appeared most important, particularly in the case of M2. Changes in deposit rates have lagged changes in market rates—a behavior exhibited quite consistently in the period since most restrictions on deposit rates were removed. With market rates rising, financial assets, other than those included in M2, became relatively more attractive to the public, the opposite of developments in 1985 and 1986. This same phenomenon, reinforced by the normal downward adjustment of compensating balance requirements as rising interest rates enable banks to earn more on business demand deposits, had a marked effect on M1 growth as well, which slowed to a 10 percent annual rate between the fourth and second quarters (and a 7¾ percent rate between the fourth quarter and June); M1 velocity appears to have changed little in the second quarter, after more than two years of steep decline.

Reflecting in large part the diminution of the federal deficit and a slowing in state and local government borrowings, influenced by the Tax Reform Act, aggregate credit expansion in the economy has slowed noticeably this year. The debt of domestic nonfinancial sectors is estimated to have expanded at about a 9¾ percent annual rate through June, still high relative to the growth of nominal GNP, but less rapid than in the past several years and within the 8 to 11 percent monitoring range specified by the Federal Open Market Committee.

Ranges for Money and Credit Growth in 1987 and 1988

At its meeting earlier this month, the FOMC did not change the 1987 ranges for money and credit growth that it had established in February. As indicated at that time, operating decisions will continue to be made not only with due regard to the behavior of these aggregates, but also in light of evidence on emerging trends in economic activity and inflation and developments in domestic and international financial markets. At this juncture, given the actual growth achieved in the first half, it seems likely that, absent major movements in interest rates that alter the incentives to hold monetary assets, expansion in M2 and M3 around the lower ends of their 5½ to 8½ percent annual ranges may well be appropriate. Indeed, should the recent tendency toward a

strengthening in velocity, which has been particularly noticeable in the case of M2, persist, or if inflationary pressures appear to be mounting, some shortfall from the annual ranges might well be appropriate. With regard to the domestic debt aggregate, the FOMC anticipated that the slower pace of debt growth in the first half would continue and that the aggregate would end the year well within the 8 to 11 percent monitoring range.

Consistent with the objective of maintaining progress over time toward general price stability, while supporting sustainable growth in economic activity, the FOMC decided to adopt, on a tentative basis, lower growth ranges for money and credit in 1988. The target growth ranges for M2 and M3 were reduced 1/2 percentage point, to 5 to 8 percent, measured from the fourth quarter of 1987 to the fourth quarter of 1988. At the same time, the monitoring range for growth of nonfinancial sector debt also was tentatively reduced by 1/2 percentage point, to 7½ to 10½ percent.

The Committee noted that M1 has continued to exhibit considerable sensitivity to changes in interest rates, among other factors, as illustrated by its sharp deceleration in the first half of this year. In view of this, and the still-limited experience with the behavior of deregulated transactions accounts, the Committee decided not to set a specific target range for M1 for the second half of 1987, and no tentative range was adopted for 1988. In its policy deliberations over the remainder of the year, the FOMC will take account of M1 growth in light of the behavior of its velocity, incoming information about the economy and financial markets, and the degree of emerging price pressures.

Economic Projections

The Committee believes that the monetary objectives that it has set are consistent with restraint on inflation in the context of continued moderate growth in economic activity and progress toward a sustainable external position. The central tendency of the forecasts of Committee members and other Reserve Bank presidents is for growth in real GNP of 2½ to 3 percent in 1987 and 1988. Between now and the end of next year, this pace of activity is expected to generate jobs in about sufficient number to match the expansion of the work force. Consequently, the civilian unemployment rate is not expected to change appreciably from the 6¼ percent average of the second quarter, although recent experience suggests that the projected growth of real GNP might lead to somewhat lower unemployment.

Real net exports of goods and services are expected to strengthen further while the growth of domestic demand remains relatively subdued. The improved competitive position of U.S. producers, resulting in large part from the dollar depreciation of the past two years, has only begun to be reflected in trade flows, and further improvement in the nation's external position should be realized in coming quarters. Household spending is expected to grow slowly, but stronger increases in business investment, especially in equipment, are anticipated as industrial firms respond to more favorable sales trends.

Prices, as measured by the implicit deflator for GNP, are expected to rise 3½ to 4 percent over the four quarters of 1987—slightly more than the central tendency range reported to the Congress in February. For 1988, projections of the increase in the GNP deflator center on 4 percent. Assuming world oil prices are more stable, there should be no repetition of the rebound in domestic energy prices that raised the general rate of inflation earlier this year. However, the acceleration in prices of non-oil imported goods, that is occurring in the wake of the decline in the foreign exchange value of the dollar, likely will continue for a time to provide some impetus to inflation, even if the dollar is more stable over the period ahead, as assumed. The size of further increases in import prices, resulting from the depreciation to date, will depend on the aggressiveness with which foreign exporters and U.S. distributors seek to restore profit margins that have been squeezed in the past two years. The view that inflation next year will not rise significantly from the pace projected for 1987 is grounded in a belief that recognition of the potential for losses of market share and job opportunities will continue to influence wage- and price-setting behavior.

While restraint on inflation is crucial in achieving an orderly adjustment as our massive external imbalance is corrected, so too is continued progress in reducing the federal budget deficit. Inflows of foreign capital will shrink in step with the reduction in our current account deficit. In that context, excessive federal borrowing requirements, as they put pressure on financial markets, pose a threat to the ability of our economy to fund necessary private capital formation.

Finally, the members of the Committee and other Reserve Bank presidents also view the prospects for a healthy U.S., and world, economy as depending significantly on the avoidance of further protectionist measures here and abroad and on satisfactory economic growth in other major industrial countries.

Economic Projections for 1987 and 1988*

		FOMC Members and other FRB Presidents	
1987		Range	Central Tendency
Percent Change, fourth quarter to fourth quarter:	Nominal GNP	5¾ to 7¼	6¼ to 7
	Real GNP	2 to 3¾	2½ to 3
	Implicit deflator for GNP	3 to 4¼	3½ to 4
Average level in the fourth quarter, percent:	Civilian Unemployment Rate	6.1 to 6.5	6.2 to 6.4
1988		Range	Central Tendency
Percent change, fourth quarter to fourth quarter:	Nominal GNP	5 to 8	5¾ to 7
	Real GNP	1 to 3	2½ to 3
	Implicit deflator for GNP	2½ to 5	3¾ to 4¼
Average level in the fourth quarter, percent:	Civilian Unemployment Rate	5.9 to 6.8	6 to 6.5

*The Administration has yet to publish its mid-session budget review, but spokesmen have indicated that earlier forecasts will be revised. As a consequence, the customary comparison of FOMC forecasts and Administration economic goals has not been included in this report.

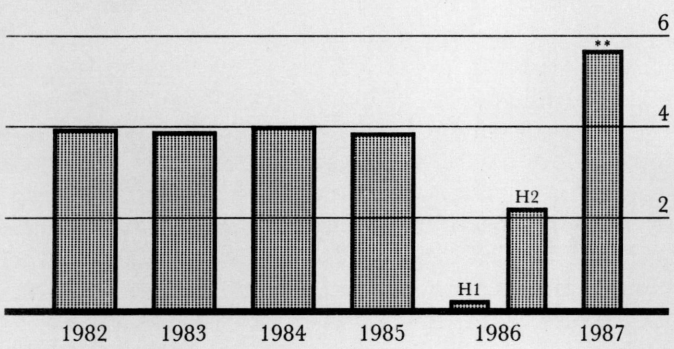
Economic Performance During the First Half of 1987

The economy continued to expand in the first half of 1987, and, in contrast to the pattern of the preceding four years, the composition of activity appeared to be moving toward a better balance between domestic spending and domestic production. The overall growth in output during the first six months of the year led to a net gain in jobs of around 1¼ million, a faster pace of hiring than during 1986. Moreover, the civilian unemployment rate, which had hovered close to 7 percent throughout most of last year, moved down to 6.1 percent by June.

Inflation picked up early this year, while most broad indexes of prices increased substantially above those of the past several years. In large part, the acceleration reflected developments in oil markets, where prices have retraced part of last year's decline. But rising prices for other imported goods also began to surface at the retail level, and, at the producer level, prices paid for raw materials and other supplies clearly turned up. Wage trends, however, have remained stable and restrained.

Consumer Prices*

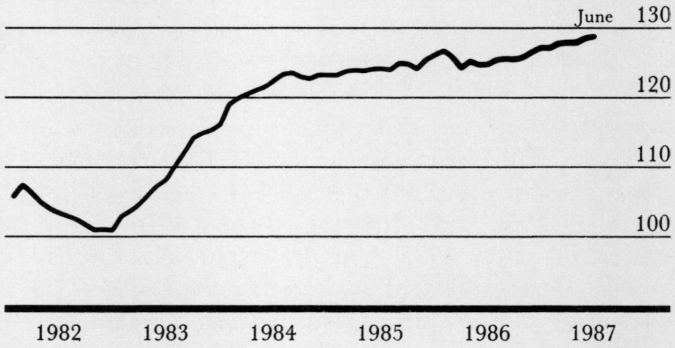
Percent change from end of previous period, annual rate



*Consumer Price Index for all urban consumers.
**Percent change from December 1986 to May 1987.

Industrial Production

Index 1977 = 100



Higher inflation rates have been, in part, a consequence of the ongoing adjustment of the U.S. economy to a lower foreign exchange value of the dollar. Prices of non-oil imports, particularly for finished consumer goods and capital equipment, have been rising at rates in excess of domestic prices in recent quarters, damping the demand for imported goods. At the same time, goods produced in the United States have become more competitive in world markets. The volume of exports, which began to pick up noticeably in the second half of 1986, continued to expand in early 1987, although the rebound likely has been limited by slow economic growth abroad.

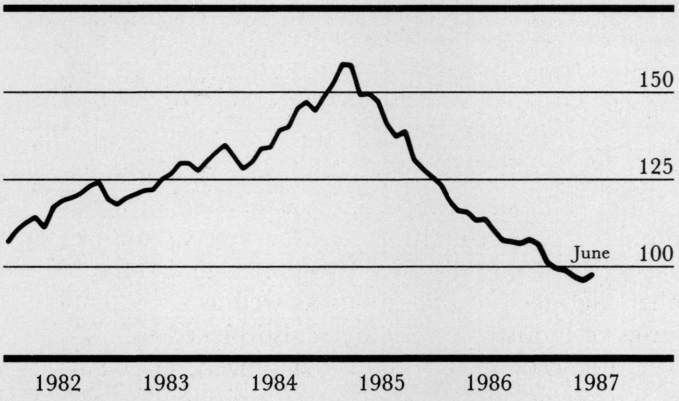
Toward the end of 1986, some manufacturing industries—notably those producing textiles, apparel, steel, chemicals, and paper—began to experience a firming in demand apparently associated with improved trade conditions. In the first six months of 1987, production of office equipment and some other high-tech capital goods as well as several categories of industrial machinery also picked up. Moreover, domestic energy output stabilized, after having been a serious drag on industrial production last year. On the whole, the pace of activity in the goods-producing sector moved back into line with the overall rise in GNP. The index of industrial production increased at a 3 percent annual rate between the third quarter of 1986 and the second quarter of 1987, after little change during the preceding year.

The External Sector

The dollar depreciated further against other major currencies in the first half of 1987, with most of the adjustment concentrated in one episode early in January and in another during a period of unsettled markets in the early spring. Since mid-May the dollar has retraced part of its recent decline, but, on a trade-weighted basis against other G-10 currencies, remains about 6 percent below its average level in December 1986, and almost 40 percent below its peak in February 1985. The underlying downward pressure on the dollar during the first half of 1987 was fueled by perceptions that progress in reducing the U.S. current account deficit had been slow and prospects for policy adjustments, here and abroad, aimed at restoring better balance in the world economy, had been disappointing. An offsetting factor until recently was the widening of interest rate differentials between the United States and the other major industrialized countries, as rates rose in the United States while they declined abroad.

Foreign Exchange Value of the U.S. Dollar*

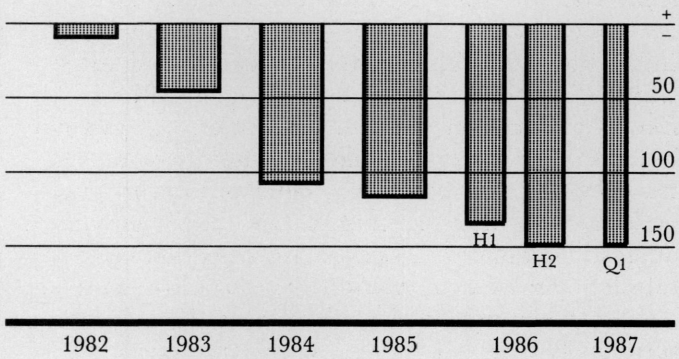
Index, March 1973 = 100



*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



The U.S. current account deficit stood at just under $150 billion in the first quarter of 1987, little changed, in nominal terms, from the deficit in the second half of 1986. The volume of merchandise imports, other than oil, was basically unchanged in recent quarters, after rising steadily for three and one-half years. Demand has leveled off for a wide range of imported industrial materials, consumer goods, and capital equipment. This adjustment, however, occurred as dollar prices for these goods began to pick up, and, thus the value of non-oil imports has continued to edge higher. Demand for imported petroleum products dropped back early this year, but with world oil prices higher, the U.S. oil import bill stayed at approximately its 1986 level.

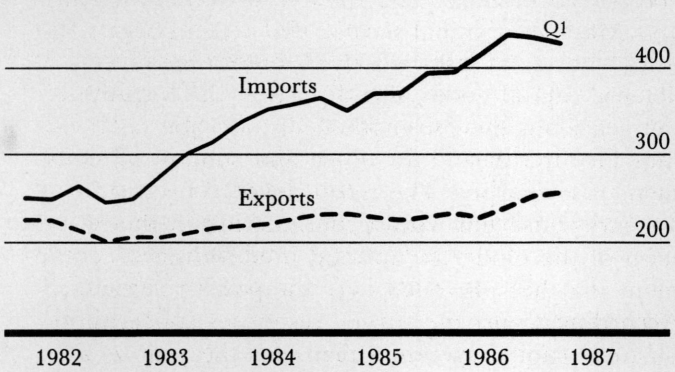
At the same time, the expansion in the volume of merchandise exports that began in mid-1986 extended into early 1987. The improvement in foreign sales has been broadly based. In particular, shipments abroad of industrial materials and capital goods, which account for the bulk of U.S. merchandise exports, both were up about 10 percent in real terms in the first quarter from the average in the first half of 1986. The recent volume of agricultural exports also firmed somewhat as sharply reduced support prices appeared to be combining with the lower dollar to boost foreign demand for some U.S. farm products.

The adjustment in the U.S. trade position to date has occurred without much impetus from economic expansion abroad. Growth of real GNP in other industrial countries averaged less than 2½ percent last year; moreover, economic activity began to slow in the second half of the year, and, at least in Europe, the weakness continued into early 1987. Export and import volumes in Europe and Japan have begun to adjust to the exchange rates movements of the past two years, cutting into the growth generated by their external sectors. While growth in domestic demand has been maintained above the rate for domestic production, it, too, has slowed and has not taken up the slack from a weak external sector.

Outside of the industrial countries, average growth last year was quite uneven and, on balance, provided only a limited offset to slower economic activity in Europe and Japan. Weakness in oil markets held down OPEC growth while the newly industrialized countries in Asia continued to expand strongly. In Latin America, which is an important market for U.S. exports, output rose close to 4 percent for a third year, a marked turnaround from the 1982–83 period when the onset of external financing difficulties seriously disrupted trade. Internal pressures to maintain reasonably strong growth persist in these countries; such growth could be facilitated by an improved performance of the industrial economies as a group.

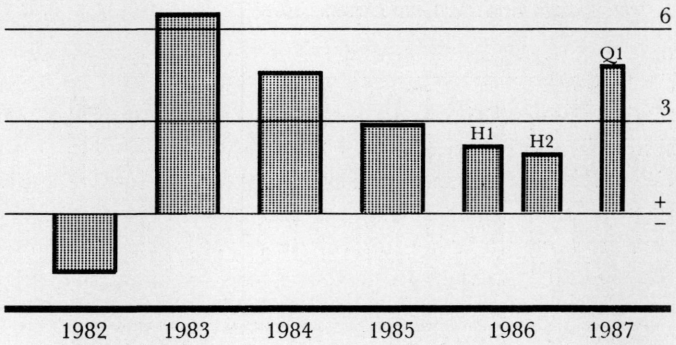
U.S. Real Merchandise Trade

Annual rate, billions of 1982 dollars



Real GNP

Percent change from end of previous period, annual rate



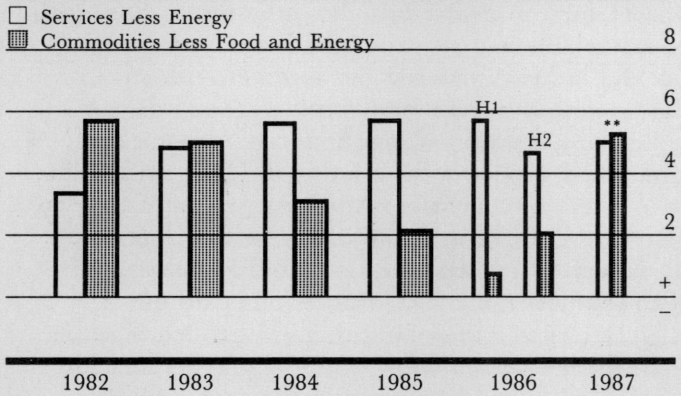
The Household Sector

Consumer spending weakened considerably in the first half of 1987, after three years in which real gains averaged 3¾ percent per annum. In particular, households cut back sharply their purchases of durable goods as outlays for nondurables flattened out. Spending for services, however, continued to trend up. Slower sales of new automobiles contributed importantly to the overall deceleration in consumer spending. During the first half of 1987, sales of new cars averaged 10 million units at an annual rate, down from a record 11½ million units in 1986. The slackening in demand was most noticeable for domestic makes and persisted despite the continuation of special incentive programs on a wide range of models.

The deceleration in consumer outlays, especially for durables such as motor vehicles, furniture, and home appliances, followed a period of several years during which a variety of factors were working to encourage households to increase their holdings of big-ticket items: relatively moderate increases, or even decreases, in the prices of many home goods; declines in interest rates; and pent-up demands from the period of economic weakness in the early 1980s.

Consumer Prices Excluding Food and Energy*

Percent change from end of previous period, annual rate



*Consumer Price Index for all urban consumers.
**Percent change from December 1986 to May 1987.

As those influences dissipated, and with the personal saving rate reaching an historically low level by late 1986, consumers apparently became more cautious in their buying patterns. Nonetheless, survey evidence still suggested that households' evaluations of market conditions for major purchases and of their personal finances remained generally positive.

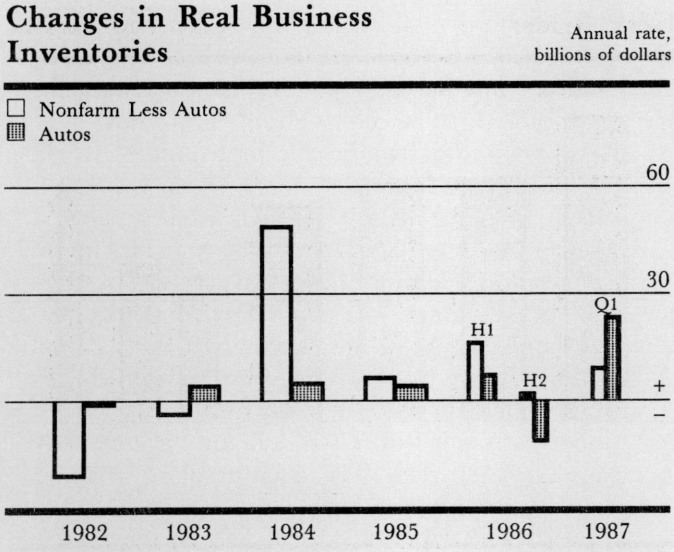
During the first five months of 1987, growth in nominal disposable income picked up from its 1986 pace; but, with consumer prices rising more rapidly, income growth, in real terms, was little different from the 2 percent pace of the preceding two years. However, the aggregate balance sheet of the household sector showed further improvement early this year. Asset holdings were bolstered especially by gains in the stock prices, while debt accumulation slowed. Growth of mortgage debt dropped back from the extraordinary pace of late 1986, despite the popularity of home equity loans, and growth of consumer credit dropped sharply. To some extent, the deceleration in consumer debt, as well as the slowdown in spending on durable goods, may be a consequence of the rapid rise in household debt burdens during the past several years. In addition, the new tax law diminished the incentive to finance expenditures with installment credit. Despite the slower growth of consumer and mortgage debt, some indicators suggest that a considerable number of households still are having problems servicing existing liabilities. Although some loan delinquency rates dropped a bit, others rose in the first quarter, as did personal bankruptcies.

Spurred by a decline in mortgage interest rates, which reached a nine-year low at the end of March, starts of new single-family homes averaged 1¼ million units at an annual rate from January through April, the highest level since the late 1970s. Sales of single-family homes, which had been boosted by tax considerations at the end of 1986, also remained brisk through April. Subsequently, the backup in mortgage rates to early-1986 levels resulted in some reduction in single-family homebuilding by May, to about the pace that prevailed last fall. In the multifamily market, the downtrend in activity that began in early 1986 continued through the first half of 1987. By May multifamily starts were almost one-third below last year's peak. Despite the adjustment thus far to overbuilding and the reduced after-tax profitability of multifamily housing investment, rental vacancy rates nationwide are still close to record levels.

The Business Sector

Business spending on plant and equipment fell sharply in the first quarter of 1987. For equipment, the weakness was concentrated in January, following the effective date of the new tax reform law. In subsequent months, shipments of nondefense capital goods recovered, leaving the average level for April and May, in nominal terms, 1¾ percent above the third quarter of last year. New orders for nondefense capital goods also dipped at the beginning of the year, but then strengthened noticeably as bookings for aircraft and for office and computing equipment rose sharply. The recent level of orders appears consistent with a continuation in the near term of the moderate uptrend in spending on equipment that has prevailed over the past two years. According to private survey responses concerning business capital spending plans for the year as a whole, firms still intend to direct the bulk of these purchases toward modernization and cost-saving improvements in their production lines.

Changes in Real Business Inventories



In contrast, the environment for expansion of plant facilities and office space is still generally unfavorable. Large amounts of vacant and underused space in both office buildings and factories began to take a toll on nonresidential construction last year. Also, less favorable treatment of commercial structures under the new tax code reinforced the tendencies toward a lower level of activity in this sector. As a result, spending for commercial and industrial buildings dropped further in the first quarter of 1987, to a level about 20 percent below a year earlier. The decline in spending for these types of buildings accounted for the overall weakness in nonresidential structures early this year, in the face of an upturn in oil drilling and some increases in other categories.

A sizable swing in business inventories around the turn of this year was associated with sharp, tax-induced fluctuations in sales. The surge in consumer and business spending at the end of 1986 was met to a considerable extent by drawing down stocks, which were then rebuilt at the beginning of this year. This spring, inventory-sales ratios generally were not indicating serious imbalances, with the notable exception of the auto industry. Domestic car makers boosted production in early 1987 in excess of slackening sales, leading to a substantial sales backlog of unsold cars on dealer lots. By June the scaling back of assemblies had stemmed further accumulation, but the industry entered the summer with stocks that were quite large by historical standards.

Before-tax profits of nonfinancial corporations, which had slipped a bit relative to GNP since 1984, rose in the first quarter. After-tax profits relative to GNP were up as well, although the rise was damped by increases in corporate tax liabilities associated with the new tax law. Corporations paid out a slightly larger share of earnings as dividends in the first quarter; nonetheless, internally generated funds remained sizable relative to investment outlays.

The Government Sector

A substantial reduction in the federal budget deficit for fiscal year 1987 appears in train, with the most recent estimate from the Congressional Budget Office at $161 billion, compared with $221 billion in fiscal 1986. Growth in receipts has been extremely rapid; this reflects, in large part, a one-time surge in tax payments this April from individuals who realized capital gains last December, taking advantage of lower tax rates under the old tax code. But more fundamental progress in reducing spending growth also appears to have been made in the wake of the Gramm-Rudman-Hollings legislation. Total outlays have been rising at a rate of around 2 percent in the current fiscal year, a marked slowing from 8 percent per year during the preceding five years.

Real purchases of goods and services by state and local governments rose at a 4 percent annual rate in the first quarter of 1987, close to the brisk pace of the past several years.

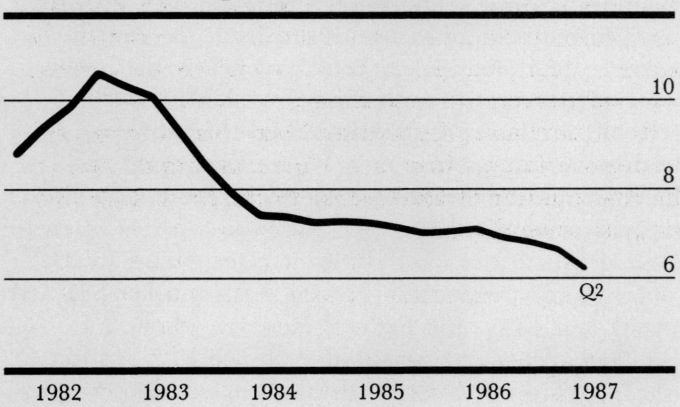
Labor Markets

Employment accelerated early in 1987, and, despite a slowing in recent months, the average monthly increase in nonfarm payroll employment of just over 200,000 so far this year exceeds the pace of hiring in 1986. The improvement in labor demand has been fairly broad based. In manufacturing, a two-year string of cutbacks in durable goods industries ended late last year, and hiring picked up a bit in the nondurable goods sector. As a result, factory employment, overall, edged higher over the first six months of 1987. In addition, the number of jobs in oil and gas extraction stabilized after the sharp retrenchment in 1986. At the same time, the expansion of jobs in the trade, services, and finance industries, despite some recent slowing, remained sizable.

The combination of strong gains in employment and declining numbers of unemployed workers over the first half of the year lowered the civilian jobless rate to 6¼ percent on average in the second quarter from just under 7 percent at the end of last year. The rate for adult men (aged 25 years and over), which remained at around 5½ percent from mid-1984 to late 1986, moved below 5 percent this spring. Further improvement also occurred for adult women, whose unemployment rate in the past year has moved below that of their male counterparts.

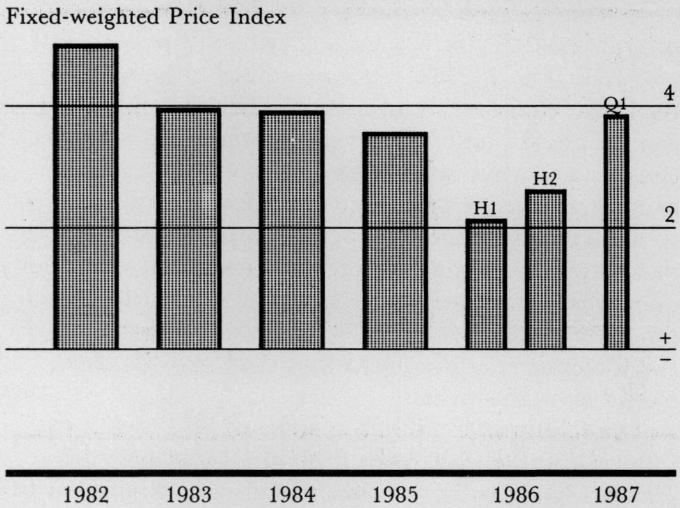
Civilian Unemployment Rate

Quarterly average, percent



GNP Prices

Percent change from end of previous period, annual rate



Price Developments

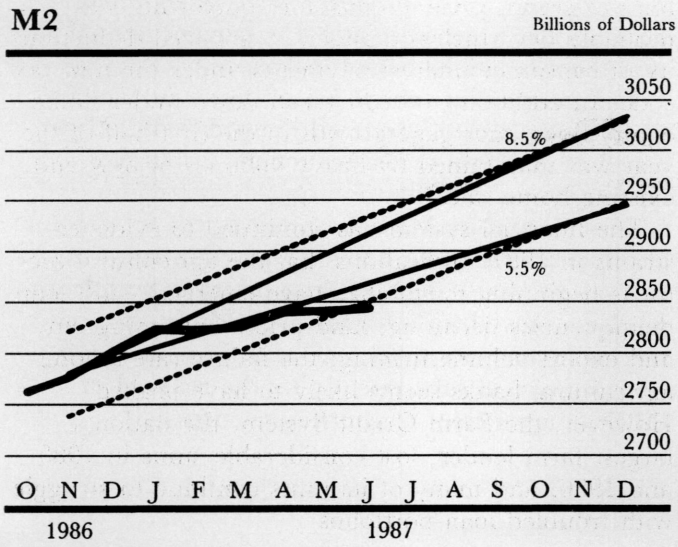
As expected, inflation rates have been higher so far this year, largely reflecting a rebound in energy prices. The GNP fixed-weighted price index, a broad measure of inflation for goods and services produced by the United States, increased at about a 4 percent annual rate in the first quarter; it had risen 2½ percent during 1986. Sharper accelerations occurred in the consumer price index, which was up at a 5½ percent rate over the first five months of the year, and in the producer price index for finished goods, which rose at a 4½ percent annual rate over the six months ended in June.

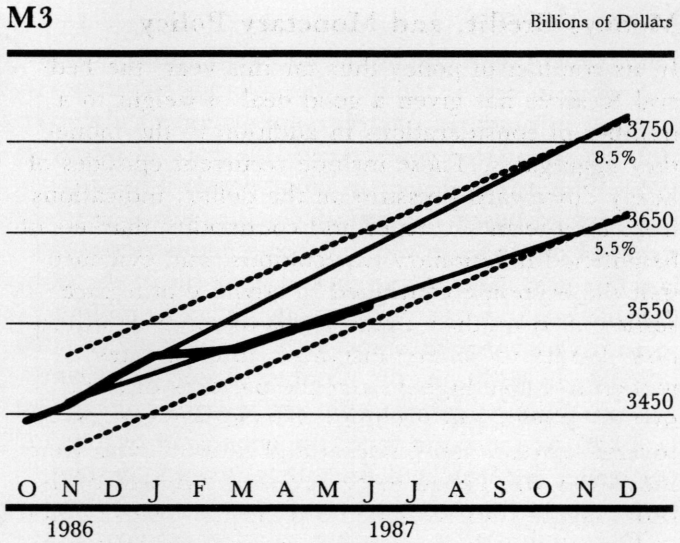
The rebound in energy prices began in January when spot prices of crude oil jumped about $3 per barrel in response to the reductions in output. Higher crude oil costs were quickly passed on to end-users, and by May consumer prices for gasoline and fuel oil had risen about 15 percent, retracing half of last year's decline. Spot prices of petroleum products moved up a bit further early in the summer as inventories tightened, and these increases were supported subsequently by the renewal of OPEC's agreement to control production.

Monetary Policy and Financial Markets in the First Half of 1987

The Federal Open Market Committee at its meeting in February established 1987 target ranges, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5½ to 8½ percent for both M2 and M3. The FOMC also set a 1987 monitoring range for domestic nonfinancial debt of 8 to 11 percent. The M2 and M3 ranges represented a 1/2 percentage point reduction from last year's target ranges, and the Committee expected growth to be well within the ranges, especially in the absence of dramatic movements in interest rates. The range for debt was unchanged from 1986 but below the actual outcome in that year and other recent years; thus, the Committee anticipated that debt growth also would slow this year.

The Committee viewed a substantial slowing in money and credit growth from the rapid pace of 1986 as likely to be consistent with a continuation of sustainable economic expansion and conducive to further progress over time toward reasonable price stability. Growth of M1 also was expected to moderate considerably this year. However, the Committee in February elected not to set a target range for M1 for 1987 because of the continuing uncertainties about the relationship of this aggregate to the economy. These uncertainties partly reflected the substantial sensitivity of its velocity to changes in financial conditions that had been evident in recent years, capped by a record postwar decline in the velocity of M1 over 1986. Instead, the FOMC decided to continue evaluating movements in this aggregate in light of the behavior of its velocity, the rate of economic expansion, inflationary pressures, and developments in financial markets.





Over the first half of 1987, monetary policy was conducted against a backdrop of heightened concerns about inflation, stimulated in part by substantial downward pressure on the dollar in foreign exchange markets. At the same time, growth of money and credit aggregates moderated considerably and the velocities of the broader aggregates turned up after several years of very rapid money growth and falling velocities. Measured from the fourth quarter of 1986, M2 in June was below the lower end of its target growth range, while M3 was around the lower end of its range. Meanwhile, growth in M1 slowed to a 7¾ percent pace and debt expansion moderated to a 9¾ percent rate. As pressures on the dollar and inflation worries intensified in April and May, interest rates began to rise substantially, especially in long-term markets. In late April and May, the Federal Reserve adopted a somewhat less accommodative stance with respect to the provision of reserves through open market operations. These actions, together with monetary easing moves by key industrial trading partners, helped to stabilize the dollar and calm inflation fears, contributing to some decline in long-term interest rates and strengthening of the dollar.

Money, Credit, and Monetary Policy

In its conduct of policy thus far this year, the Federal Reserve has given a good deal of weight to a number of considerations in addition to the monetary aggregates. These include recurrent episodes of heavy downward pressure on the dollar, indications from long-term securities and commodity markets of heightened inflationary expectations, and evidence that the economy continued to advance at a pace sufficient to produce rising levels of resource utilization. Under these circumstances, interest rates tended to move higher, and the patterns of rapid money growth and declining velocities of the last several years, when inflation and interest rates were moving down, began to be reversed. Growth of the broad aggregates remained around the lower bounds of their growth cones through most of the first half of the year, although M2 dropped well below its long-run range later in the period. Growth of both M2 and M3 was considerably below the pace of recent years, and their velocities increased. Expansion of M1 also slowed markedly, while growth of domestic nonfinancial sector debt moderated.

Long-term interest rates, which had not been affected very much by the transitory credit demands of late 1986, continued to drift down in the early months of 1987, displaying little short-term volatility. The placid conditions in long-term markets were abruptly changed in late March, primarily by developments in the international sphere. Announcements of trade sanctions by the United States, persisting weakness of the dollar, and disappointing trade figures all raised questions about continuing private demands for dollar assets, prospects for inflation, and the response of monetary policy. The dollar dropped sharply in the last three weeks of March, and between late March and late April yields on 30-year government bonds rose about 1 percentage point on balance. The exchange and bond markets became highly volatile during this period, as the dollar continued to drop and inflation fears appeared to be intensified by the publication of adverse price data. Mortgage rates and yields on mortgage pass-through securities reacted very promptly to the deterioration in the bond markets and, indeed, rose more than most other long-term rates as many investors shied away from these instruments subject to substantial prepayment risk.

The effects of these developments also were evident in short-term credit markets, where rates rose in April partly in anticipation that monetary policy would have to firm to contain pressures on prices and the dollar. In late April and again in May, the Federal Reserve did move to tighten the availability of nonborrowed reserves through open market operations. Short-term interest rates rose about 1/2 to 3/4 percentage point during April and May, and the prime rate was raised twice, on May 1 and May 15, in 1/4 point increments. The System's firming actions, along with complementary moves abroad, helped to stabilize the dollar and ameliorate the concerns about the inflation outlook.

Along with some better price news and evidence of improvement in our trade deficit, this policy appeared to impart an improved tone to short-term and, especially, long-term credit markets over the latter part of May and June. Since May, most short-term rates have posted declines of 1/4 percentage point or more. Longer-term markets generally have registered greater gains, and in early July long rates were off 1/2 to 3/4 percentage point from their May highs. The dollar, meanwhile, has shown more dramatic improvement, regaining most of the ground it lost in April and May.

Consumer use of installment credit was considerably diminished during the first half of the year. To some degree, this reflected a shift to mortgage debt in the form of loans taken down under home equity lines of credit. Overall consumer borrowing was probably nevertheless damped by reduced deductibility of consumer interest payments under the new tax code. In addition to credit taken down under home equity lines, mortgage growth in the first half of the year was maintained by heavy volumes of new and existing home sales.

The financial system has continued to evidence strains in 1987. Indications that the agricultural sector is beginning to stabilize have emerged, with loan delinquencies declining, land prices bottoming out, and export volume firming; the failure rate among agricultural banks seems likely to have peaked. However, the Farm Credit System, the nation's largest farm lender, lost considerable sums in 1985 and 1986, and many of its units continue to struggle with troubled loan portfolios.

In addition to difficulties with agricultural loans, commercial banks have been saddled with persisting problems in their energy and developing country loan portfolios. Although some banks remain highly profitable, 19 percent lost money last year, compared with about 3 percent as the decade began; loan loss provisions were the main cause of the earnings problems. The banking system is likely to post record losses this year owing to huge reserve provisions taken by large banks primarily as a consequence of developments in the international debt area. Despite the shrinkage in the book value of shareholder equity recognized by these actions, share prices rose at many banks announcing large increases in loan loss reserves.

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

Period		M1	M2	M3	Domestic Nonfinancial Debt
Fourth quarter 1986 to second quarter 1987		9.9	4.5	5.3	9.8[e]
Fourth quarter 1986 to June 1987		7.7	4.0	5.3	9.8[e]
Fourth quarter to fourth quarter	1979	7.9	8.2	10.4	12.2
	1980	7.3	8.9	9.6	9.6
	1981	5.1 (2.4)[1]	9.3	12.3	9.9
	1982	8.6	9.1	9.9	8.9
	1983	10.2	12.1	9.8	11.5
	1984	5.4	7.9	10.7	13.9
	1985	12.1	8.8	7.7	13.4
	1986	15.3	8.9	8.8	13.2
Quarterly average 1986	Q1	8.8	5.3	7.7	15.5
	Q2	15.5	9.4	8.7	10.2
	Q3	16.5	10.6	9.7	12.5
	Q4	17.0	9.2	8.0	12.1
Quarterly average 1987	Q1	13.1	6.3	6.3	10.4
	Q2	6.4	2.5	4.1	9.0[e]

e—estimated

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

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 Eudodollar 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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