1988

MONETARY POLICY OBJECTIVES

Midyear Review of the Federal Reserve Board

July 13, 1988

1988

MONETARY POLICY OBJECTIVES

This Executive Summary provides highlights of the Board's Midyear Review to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978.

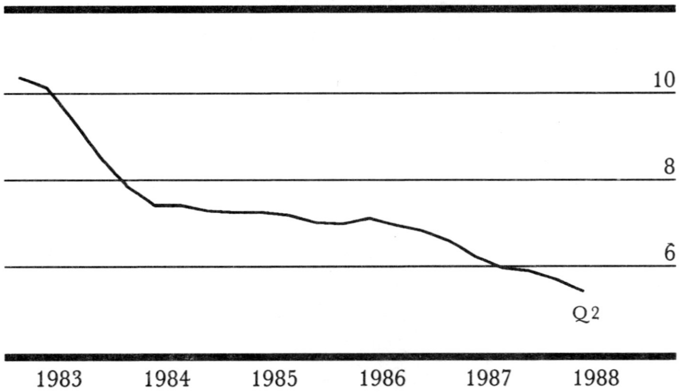
Contents

Monetary Policy and the Economic Outlook for 1988 and 1989

The economy continued to expand rapidly in the first half of 1988, displaying impressive resilience in the wake of last fall's stock market break. Especially encouraging has been the fact that the expansion in activity this year has been propelled largely by rising exports and business investment, which bodes well for the restoration of better balance in the economy.

With the industrial sector continuing to enjoy greater growth, capacity utilization rates have crept higher. At the same time, the civilian unemployment rate has declined since year-end, and the average of 5½ percent in the second quarter was the lowest in nearly 15 years. Despite the tightening of labor markets, wage increases to date have been notably restrained, on balance, helping to contain cost pressures in many sectors. Most measures of price inflation among finished goods and services also have shown little if any pickup, although basic commodity prices have risen considerably, most recently reflecting the effects of drought on agricultural markets.

Civilian Unemployment Rate Quarterly average, percent



During the first half of the year, the Federal Reserve continued to direct its policies toward providing monetary and financial conditions that would foster price stability over time, promote sustainable economic growth, and contribute to an improved pattern of international transactions. It was recognized that progress toward these goals in 1988 would require relatively slow growth of domestic demand, which would allow the economy to accommodate rising external demands on U.S. producers without generating overall inflationary pressures. Consistent with continued external adjustment and with its commitment to achieving price stability over time, the Federal Open Market Committee (FOMC) in February lowered its 1988 target growth ranges for the broader measures of money—M2 and M3—to 4 to 8 percent.

Monetary Plans for the Remainder of 1988 and for 1989

At its meeting last month, the Federal Open Market Committee agreed to retain the 4 to 8 percent target growth ranges for M2 and M3, measured from the fourth quarter of 1987 to the fourth quarter of 1988. In addition, the Committee retained the 7 to 11 percent monitoring range for the debt of domestic nonfinancial sectors and again set no range for M1, the narrowest measure of money. Recognizing the variability of the relationship of these measures to the performance of the economy, the Committee agreed that operating decisions would continue to be made not only in light of the behavior of the monetary aggregates, but also with due regard to developments in the economy and financial markets, including attention to the sources and extent of price pressures and to the performance of the dollar in foreign exchange markets.

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

	1987	1988	Provisional for 1989
M2	5½ to8½	4 to 8	3 to 7
M3	5½ to 8½	4 to 8	3½ to 7½
Debt	8 to 11	7 to 11	6½ to 10½

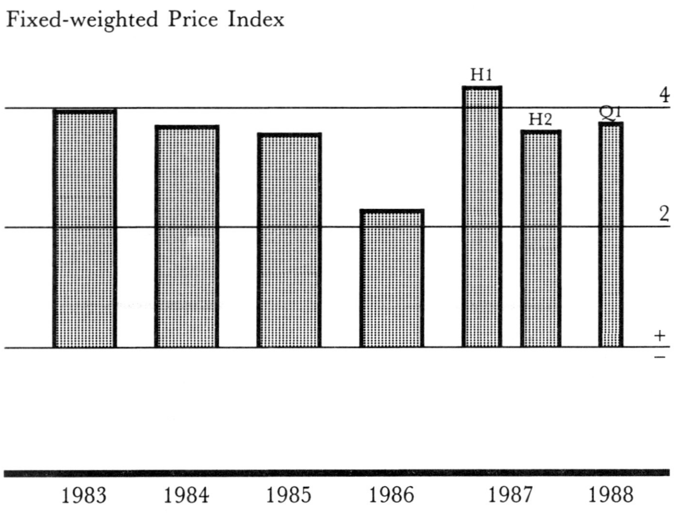
In the absence of any significant economic and financial disturbances, the Committee expected growth in M2 to moderate over the remainder of the year, placing the aggregate around the middle of its target range at year-end. Growth in M3 this year is expected to exceed that of M2 but to remain comfortably within its range, on the assumption that asset expansion at depository institutions would remain fairly robust in the second half. The debt of domestic nonfinancial sectors is expected to remain near the middle of its monitoring range, which would put its growth for the year around the slowest annual pace registered in the past decade.

For 1989, the Committee set, on a tentative basis, target growth ranges of 3 to 7 percent for M2 and 3½ to 7½ percent for M3, measured from the fourth quarter of 1988 to the fourth quarter of 1989; the monitoring range over the same period for domestic debt was set at 6½ to 10½ percent. Although uncertain about how strong the economy might be over the coming year or so, the Committee recognized that, given the current high levels of resource utilization, it was necessary to be particularly attentive to inflationary risks. An acceleration of inflation could undermine the sustainability of the economic expansion and the international competitive position of U.S. producers. The lower ranges tentatively adopted for 1989 were believed consistent with a monetary policy that would curb any tendency for inflation to worsen and would contribute over time to the restoration of price stability. However, the Committee also noted that developments over the next half year could alter substantially the rates of money growth needed to foster satisfactory economic performance in 1989 and beyond. Consequently, it stressed the provisional nature of its decision and the possibility that the ranges for 1989 might need to be adjusted when they are reviewed early next year.

The Committee again decided not to set a range for M1, given the sharp swings in its velocity in recent years, resulting in part from its increased sensitivity to movements in market interest rates since deposits were deregulated. In considering narrow monetary measures, the Committee also has discussed whether the monetary base could play a useful role in the conduct of policy. This measure comprises the major monetary liabilities of the Federal Reserve System—currency in the hands of the public and reserves of depository institutions—and represents, in a sense, the "base" of the broader monetary aggregates. The Committee decided against establishing a range for the monetary base, because it seemed unlikely to provide a more reliable guide for policy than the aggregates for which ranges already are established. Although the base has been less variable in relation to economic activity and prices than M1, its velocity nonetheless has fluctuated appreciably and rather unpredictably from year to year.

GNP Prices

Percent change from end of previous period, annual rate



Economic Projections

As indicated in the table, the central tendency of the forecasts of Committee members and nonvoting Reserve Bank presidents is for growth in real GNP of 2¾ to 3 percent in 1988, with a modest slowing of expansion in 1989. Such a pace of growth likely would generate employment gains sufficient to hold the civilian unemployment rate close to its average second-quarter level of 5½ percent. Prices, as measured by the implicit deflator for GNP, are generally expected to rise 3 to 3¾ percent over the four quarters of 1988, similar to last year's rate of advance. For 1989, projections of the increase in the GNP deflator are of course more uncertain, and the central-tendency range widens to 3 to 4½ percent.

Continued improvement in the external sector is expected to provide the main impetus to U.S. economic growth over the next 18 months. Real exports of goods should remain on a strong upward path, reflecting the improved competitive position of U.S. producers. At the same time, the growth of real imports is likely to be restrained, owing to the lagged effects of the depreciation of the dollar through the end of last year. This continued shrinkage of the real trade deficit is expected to be sufficient to generate some reduction in the nation's deficit on current account during 1988 and a further decline in 1989.

In contrast to the boost provided by the external sector, domestic demand is projected to remain relatively subdued. Consumer spending, in particular, has been on a sluggish growth trend since late 1986,

Economic Projections for 1988 and 1989

		FOMC Members and other FRB Presidents		Administration
1988		Range	Central Tendency	
Percent Change, fourth quarter to fourth quarter:	Nominal GNP	4 to 7	5¾ to 6¾	6.6
	Real GNP	1 to 3¼	2¾ to 3	3.0
	Implicit deflator for GNP	2¾ to 4	3 to 3¾	3.5
Average level in the fourth quarter, percent:	Civilian Unemployment Rate	5¼ to 6½	5¼ to 5¾	5.5
1989		Range	Central Tendency	
Percent change, fourth quarter to fourth quarter:	Nominal GNP	4 to 7½	5 to 7	7.1
	Real GNP	1 to 3	2 to 2½	3.3
	Implicit deflator for GNP	2 to 5	3 to 4½	3.7
Average level in the fourth quarter, percent:	Civilian Unemployment Rate	5 to 7	5½ to 6	5.3

and that pattern seems likely to persist. Moreover, in an environment of more moderate growth of overall activity, economy-wide spending on new plant and equipment may not rise as swiftly as it has on average over the past year. Even so, within manufacturing, improved profitability and higher capacity utilization have stimulated a healthy pickup in capital spending, which should continue for some time.

The performance of the interest-sensitive sectors, most notably homebuilding and business investment, will be influenced considerably by the extent to which the federal government is competing for available supplies of credit. Accordingly, continued fiscal restraint is essential if we are to free up resources to support private investment. In this regard, the budget summit agreement reached last December was a favorable first step, and the members of the Federal Open Market Committee and other Reserve Bank presidents have assumed that the necessary legislative action will be taken to implement the agreement. There is a clear need for further initiatives to deal with the out-year deficits, which remain distressingly large; financial events later this year and in 1989 could be substantially affected by the developments in the fiscal arena.

Although little change is expected in the overall pace of inflation this year, as compared with 1987, the sources of actual and potential price pressures appear to have changed. In 1987, a rebound in oil prices was a major factor boosting the general price level; assuming that world oil prices remain fairly stable, domestic energy prices should not be a significant inflationary force in 1988–89. Labor markets have tightened considerably since last year, however, and most measures of wage and compensation rates have firmed. Although the overall rate of industrial capacity utilization is not high by historical standards, plants are being used very intensively in some materials-producing sectors; sharply rising materials prices have raised costs for manufacturers generally. Food prices also have been a less favorable element in the inflation picture recently, and are likely to experience some further acceleration as a consequence of drought conditions; however, it is important to recognize the temporary nature of this phenomenon, which should have no lasting effect on overall inflation so long as it does not become embedded in wage trends.

For 1989, the FOMC central-tendency range for the GNP deflator widens on the upper end, suggesting the possibility of a pickup in inflation from the pace this year. However, this apparent acceleration of prices largely reflects the arithmetic implication of an eccentric movement in the deflator for GNP in the first quarter of this year. Shifts in the composition of output caused the deflator to rise at less than a 1½ percent annual rate during that quarter; these shifts are not expected to be so noticeable in coming quarters.

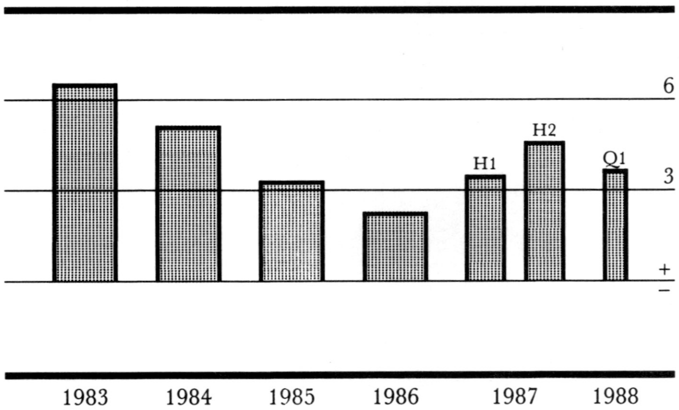
The Performance of the Economy during the First Half of 1988

The economy continued to expand briskly in the first part of 1988. Activity was boosted by strength in capital spending and growth in foreign demand for U.S. goods. The rise in overall output during the first six months of this year supported the addition of about 1¾ million jobs to nonfarm payrolls, and the civilian unemployment rate, which had trended down throughout 1987, has dropped somewhat further since the beginning of the year to an average level of 5½ percent in the second quarter.

Despite the greater tightness in labor markets and the higher rates of capacity utilization now prevailing in some industries, tendencies toward additional inflation have been limited. Prices of materials and components have risen sharply, but for finished goods there are only hints of price acceleration outside the food sector. Wages, on the whole, have continued to be fairly well behaved, suggesting a recognition on the parts of labor and management of the need to maintain competitive cost structures.

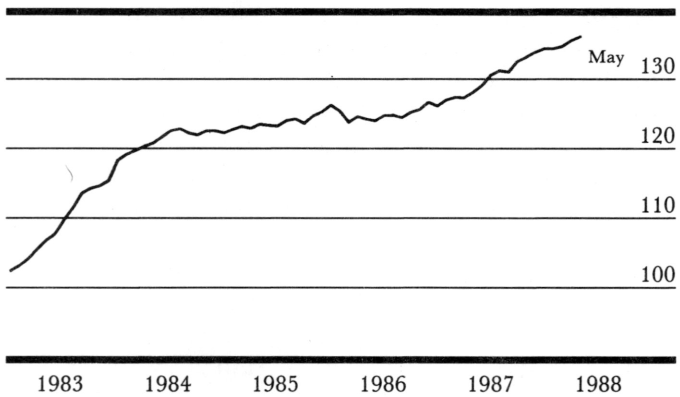
Real GNP

Percent change from end of previous period, annual rate



Industrial Production

Index 1977 = 100



The continued resurgence of manufacturing has been one of the most notable economic developments this year. During the first five months of 1988, industrial production expanded at nearly a 4 percent annual rate, and the rate of capacity utilization for total manufacturing rose 1/2 percentage point between December and May to just over 83 percent, the highest level during the 1980s. Owing to these advances in production, manufacturers have embarked on substantial programs to invest in plant and equipment, pacing an economy-wide pickup in the rate of capital spending. The better balance of expansion also has been visible in agriculture, although the upturn in that sector has been jeopardized by recent drought conditions.

The improvements in manufacturing and agriculture are, in part, reflections of a broader adjustment of the U.S. external position. The combination of a lower dollar and domestic cost containment has translated into a marked turnaround in real net exports. That process also has been aided by stronger economic growth in other large industrial countries.

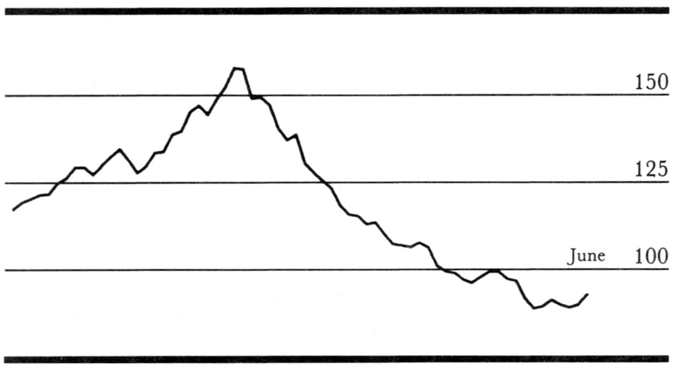
The External Sector

After having trended down for nearly three years, the dollar appreciated substantially over the first half of 1988 against most major foreign currencies. The dollar rose sharply at the beginning of the year, responding in part to coordinated central bank intervention. In recent months, sentiment toward the dollar appears to have improved, owing largely to the release of better-than-expected trade reports and to firming actions by the Federal Reserve.

The U.S. merchandise trade deficit for the first quarter was $144 billion at a seasonally adjusted annual rate, substantially below the figures for the fourth quarter and for 1987 as a whole. In April, the trade deficit narrowed further. Exports have continued to expand rapidly, while import growth has slowed considerably. The strong growth of exports can be attributed primarily to the increased price competitiveness of U.S. goods, which reflects the decline of the dollar in recent years and the tight control over production costs exercised by domestic firms. This growth of exports continues to be broadly based, and foreign sales have been particularly strong for industrial machinery and for computing equipment.

Foreign Exchange Value of the U.S. Dollar*

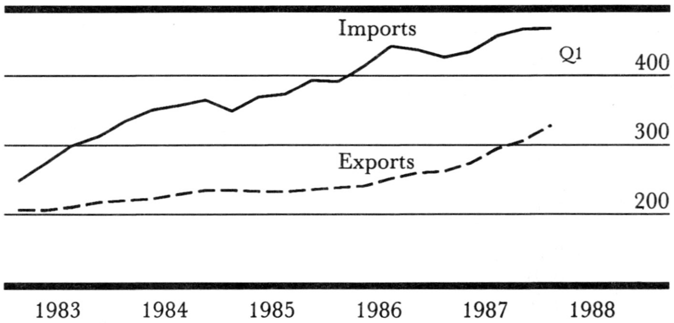
Index, March 1973 = 100



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

U.S. Real Merchandise Trade

Annual rate, billions of 1982 dollars



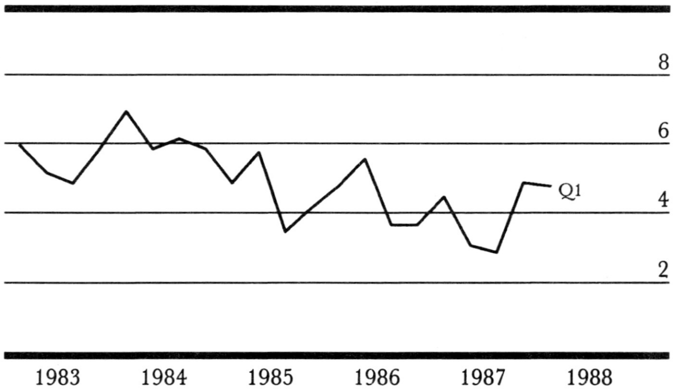
The Household Sector

Consumer spending showed some vigor in early 1988, after declining in the fourth quarter of last year. Real outlays increased at a 3¾ percent annual rate in the first quarter, as purchases of motor vehicles bounced back with the expansion of manufacturers' incentive programs, outlays for other durable goods were strong, and expenditures on services continued to post appreciable gains. Data for April and May suggest, however, that the growth of consumer spending slowed from the rapid first-quarter rate.

The buoyancy of consumer spending early this year can be traced to robust income growth. Real disposable personal income rose at a 5 percent

Personal Saving Rate

Percent of disposable income



annual rate, on average, during the fourth quarter of 1987 and the first quarter of 1988, substantially above the 2 percent rate posted for 1987 as a whole. However, disposable income growth appears to have slowed considerably in the second quarter, as a result of a spurt in nonwithheld tax payments and a slower pace of employment gains.

Although the pace of consumer spending thus far this year has been stronger than many expected, the stock market break probably did exert some restraining effect. This is evident in the personal saving rate, which has averaged 4½ percent for the seven months after October—one percentage point above the average level during the first three quarters of 1987. While most households experienced little direct loss of wealth from the stock market decline, the startling dimensions of the event obviously affected consumer sentiment last fall. With each passing month, however, confidence has grown and helped to sustain the growth of spending.

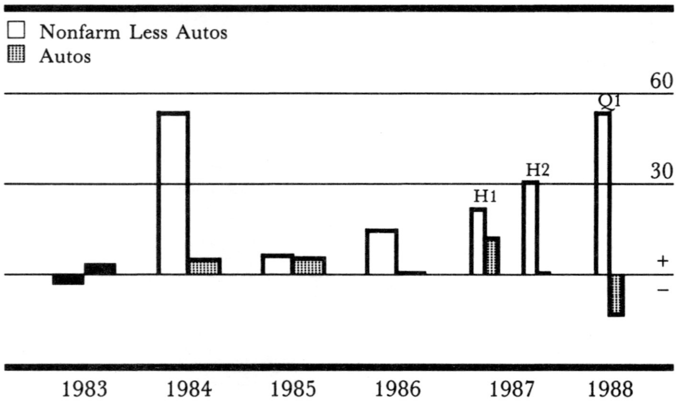
Residential construction was weak during the first half of 1988. Total housing starts averaged about 1½ million units at an annual rate through May, almost 9 percent below the 1987 total. In the multifamily sector, building declined from the already depressed 1987 level. Starts in this sector have been falling since the end of 1985, as near-record vacancy rates and changes in the tax laws have reduced the incentive to build new units. In the single-family sector, building has fluctuated from month to month, influenced by movements in interest rates and perhaps by weather; on balance, the average level of starts through May was roughly 6 percent below the 1987 pace.

The Business Sector

Business fixed investment advanced sharply in the first quarter of 1988, owing to a large increase in purchases of equipment. In recent months, spending appears to have remained near the high first-quarter level. Surveys of capital spending plans, taken this spring, point to appreciable growth in investment outlays over the second half of 1988.

Changes in Real Business Inventories

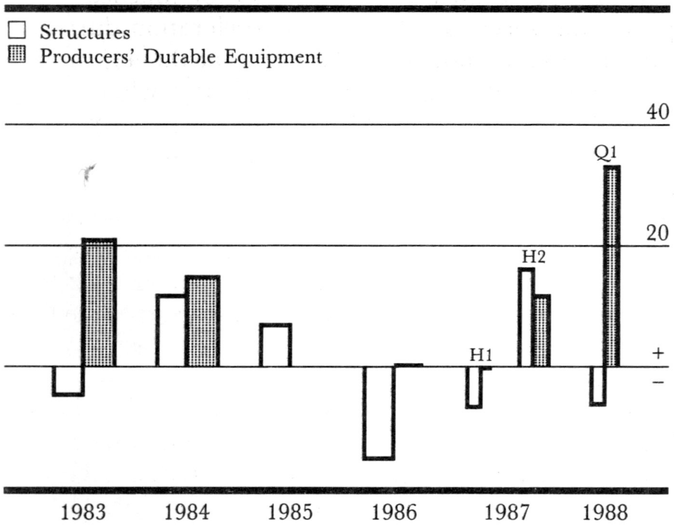
Annual rate, billions of 1982 dollars



Real outlays for computing equipment jumped at more than a 90 percent annual rate in the first quarter, but fell back considerably in subsequent months. Smoothing through this volatility, it appears that demand for such equipment has emerged from the lull that prevailed during 1986 and the first half of 1987, when excess computing capacity—as well as concerns about the usefulness of available software—limited purchases. Outlays for other types of equipment also have been strong, on balance, since the turn of the year, largely reflecting the buoyancy of overall economic activity. In particular, with utilization rates now at elevated levels in many manufacturing industries, equipment investments have been an attractive way of removing bottlenecks and achieving a relatively rapid improvement in effective capacity.

Real Business Fixed Investment

Percent change from end of previous period, annual rate



The pace of business inventory investment moderated somewhat during the first four months of 1988, reducing the concern about excessive stocks that had arisen earlier this year. This concern had focused on the retail sector, where inventories at auto dealers and at certain outlets for nondurable goods (primarily general merchandise and apparel stores) appeared high relative to sales at year-end. By cutting production early in the year and offering a variety of sales incentives, automakers have been able to bring their inventories into better alignment with sales. In contrast, inventory-to-sales ratios for nondurable retail goods continue to hover at levels that are high by historical standards. At the manufacturing level, inventory positions through May appeared fairly lean in general, given the pace of shipments. Much of the recent building of factory stocks has been in industries where market demand has been robust, such as aircraft, machinery, chemicals, and paper.

The Government Sector

In real terms, federal government purchases of goods and services—which add directly to GNP and account for about one-third of total federal expenditures—fell during the first quarter and appear to have remained relatively weak in recent months. This dropoff reflects the winding down of some major defense procurement programs, restraint on domestic discretionary spending, and net reductions in farm inventories held by the Commodity Credit Corporation. However, on a budget basis, total outlays have been growing rapidly, owing to continued increases in entitlements, greater demands on deposit insurance agencies, and increasing net interest payments.

Meanwhile, growth of federal government revenue has slowed compared with the sharp increase in FY1987. Although tax receipts have been pushed up by the robust gains in income and by an increase in the payroll tax rate, this upward impetus to revenue has been tempered by the final reductions in income tax rates from the reforms enacted in 1986. In contrast to its effects this year, tax reform had provided a substantial boost to revenues in FY1987. On balance, it is quite possible that the budget deficit this year will exceed the $150 billion shortfall recorded last year.

Labor Markets

Early in the year, incoming data seemed to signal some weakening of labor demand. Initial claims for unemployment insurance, which had trended up during the final months of 1987, rose even further just after the turn of the year. Moreover, the first report on nonfarm payroll employment for January showed the smallest monthly increase since mid-1986. Taken together, these indicators conveyed a picture of deterioration in the labor market. However, as subsequent data were released, it became clear that the underlying pattern of labor demand had, in fact, remained healthy. Claims for unemployment insurance dropped back to relatively low levels and the anemic employment gains for January were revised up substantially. Moreover, since January, nonfarm payroll employment has advanced more than 300,000 at a monthly rate, somewhat above the average increase in 1987. Although the gains have been concentrated in the service-producing sector, manufacturing has posted an average monthly increase of about 30,000 jobs thus far this year, with the largest advances in the machinery and metals industries.

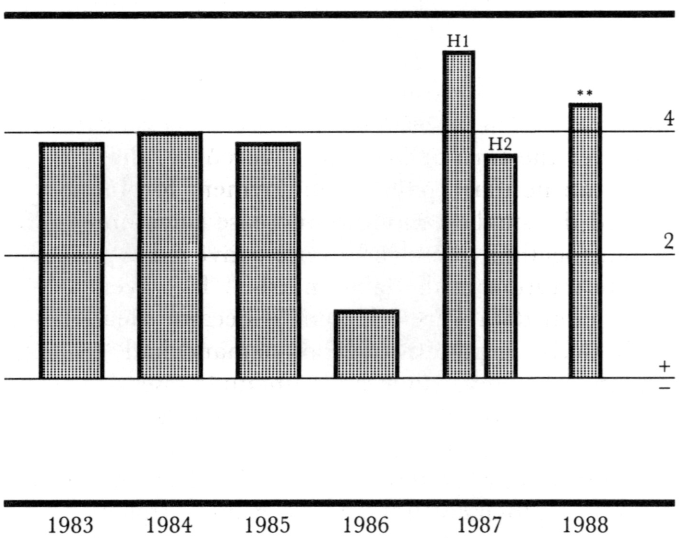
The combination of strong gains in employment and slower growth of the labor force over the first half of 1988 lowered the civilian jobless rate to 5.3 percent in June from 5.8 percent at the end of last year. Jobless rates fell for a broad spectrum of demographic groups over the first half of the year, and the June rate of unemployment represents the lowest monthly figure since mid-1974. The June level, however, may be artificially low, owing to the difficulty of adjusting for seasonal swings in employment at the end of the school year.

Price Developments

Upward pressures on prices appear to have grown stronger this year, reflecting the lagged effects of the earlier depreciation of the dollar, as well as tighter markets for labor, industrial materials, and farm output. Energy prices, in contrast, have been restrained this year, on balance, and have provided some offset to these pressures. For the most part, signs of higher inflation have been confined to price

Consumer Prices*

Percent change from end of previous period, annual rate



*Consumer Price Index for all urban consumers.
**Percent change from December 1987 to May 1988.

indicators for commodities and intermediate goods, which have posted sharp increases. The consumer price index—a measure of inflation for finished goods and services—showed no acceleration during the first five months of 1988, rising at the 4½ percent annual rate registered for 1987 as a whole.

In the agricultural sector, tighter crop inventories and stronger grain exports pushed up farm-level prices early in 1988. In addition, prices for grains and soybeans recently have surged in commodity markets, owing to the drought in major growing regions. It now appears likely that retail food prices will accelerate in coming months and exert some upward pressure on aggregate consumer price inflation.

At earlier stages of processing, inflation appears to have picked up for a wide range of items. On commodity markets, prices of crude industrial materials have remained on an upward course this year, although the price hikes have been less pervasive than in 1987. Reflecting, in part, these developments, the producer price index for intermediate materials other than food and energy rose at nearly an 8 percent annual rate over the first five months of this year, up from the 5 percent pace registered last year. Price increases have been especially large for materials used by producers of metals, chemicals, paper, and plastic, where output has been strong or capacity utilization rates high.

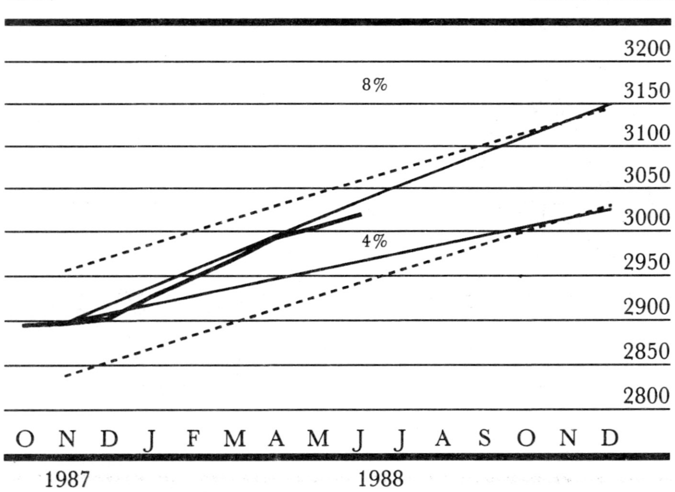
The upward movement of intermediate goods prices relative to finished goods prices at the producer level has been quite substantial. Although divergences in the two series, such as the one that has arisen over the past year, are not unprecedented, disparities typically have not persisted for long. Historical evidence indicates that higher materials costs, on average, pass through rather quickly into finished goods prices. In the recent period, the effect of the sharp rise in materials prices may have been cushioned by restraint on unit labor costs, by the spreading of overhead costs over larger sales volumes, and, perhaps, by efforts to save on or substitute away from higher cost materials. Nonetheless, past experience suggests that, even if there may not be a significant delayed pass-through in coming months, the risks of an acceleration in finished goods prices would be considerable if the pressures on materials prices do not ease soon.

Monetary Policy and Financial Markets during the First Half of 1988

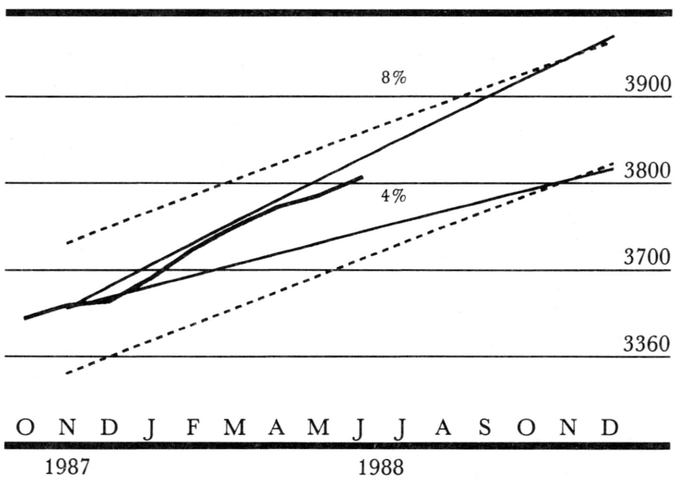
The Federal Open Market Committee has sought monetary and financial conditions that promote price stability over time, support sustainable economic growth, and contribute to an improved pattern of international transactions. To this end, the Committee at its February meeting established target ranges, measured as growth rates from the fourth quarter of 1987 to the fourth quarter of 1988, of 4 to 8 percent for both M2 and M3. It also set a monitoring range of 7 to 11 percent for the growth of domestic nonfinancial debt and chose, once again, not to stipulate a range for M1 growth. The 1988 target ranges for M2 and M3 represented reductions from last year's ranges of 5½ to 8½ percent for both aggregates and resulted in a lowering of the midpoint of the target ranges by one full percentage point.

During the first part of 1988, monetary policy was conducted against a backdrop of data suggesting some weakness in the economic expansion. Reflecting concern about the outlook for economic growth, the Committee moved in January to ease slightly the degree of pressure on reserve positions. On balance, interest rates fell during January and February, which, in conjunction with rate declines that followed the stock market drop in October, contributed to a pickup in M2 and M3 growth over the first quarter of the year.

M2



M3



As information suggesting greater economic strength and an increased potential for a build-up of inflationary pressures became available in March and in subsequent months, and with M2 and M3 running near the upper ends of their growth ranges, the Committee moved, in several steps, to tighten reserve pressures. Owing to the force of credit demands and the Federal Reserve's less accommodative posture, interest rates rose on balance over those months. Late in the second quarter, growth in the aggregates moderated, leaving both well within their target ranges as the first half of 1988 ended.

Behavior of Money and Credit

From the fourth quarter of 1987 through June 1988, M2 increased at about a 7 percent annual rate, a noticeable increase over its 1987 rate of 4 percent. The faster growth can be attributed primarily to the lagged reaction of the public's demand for M2 balances to decreases in market interest rates relative to deposit rates that occurred in late 1987 and early 1988. In the second quarter of 1988, however, the "opportunity cost" of holding M2 reversed its downward trend, and growth in M2 moderated toward the end of the period.

M3 growth increased in the first half of 1988 to a 7 percent rate, following a 5½ percent increase in 1987. Credit expansion at banks and thrift institutions, which heavily influences the overall behavior of M3, remained at roughly the same pace as last year, but it was financed to a greater extent over the first half of the year by liabilities included in M3. In particular, inflows to banks from their foreign branches and borrowings by savings and loans from Federal Home Loan Banks, which are not included in M3, dropped off sharply compared with 1987.

M1 grew at a 5 percent rate during the first half of the year, which although below the 6¼ percent rate for all of 1987, was higher than its growth in the second half of last year. The sluggish growth of M1, especially in comparison to that of M2 and M3, owed entirely to weakness in demand deposits, which have been declining over the past 18 months. In contrast, growth in currency and other checkable deposits was robust.

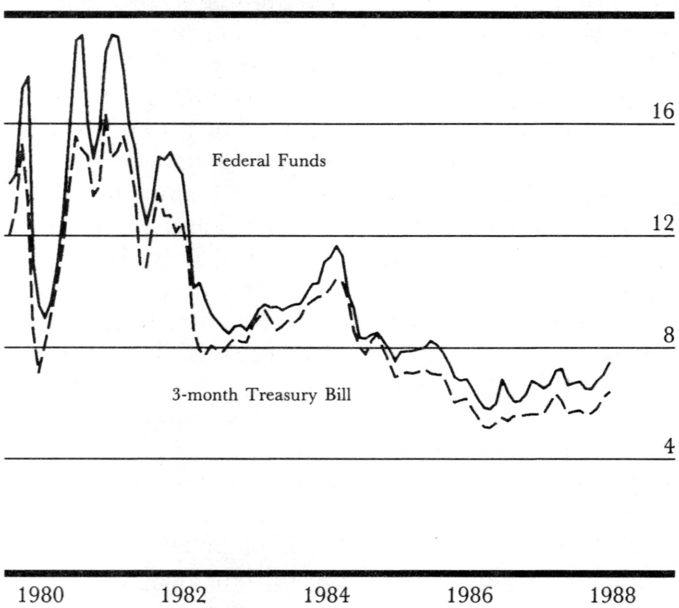
Domestic nonfinancial debt grew at a 8½ percent rate from the fourth quarter of 1987 to June, according to estimates based on partial data. Debt growth in the first half represented a slowdown from last year's 9½ percent rate and a substantial decline from the 13¼ percent rate of expansion in 1985 and 1986. Nonetheless, debt continued to grow faster than nominal GNP. Reflecting the effects of smaller federal deficits during the calendar year, growth in federal debt slowed from last year's pace and remained at a rate well below that recorded over most of the 1980s. Nonfederal debt also expanded at a somewhat slower rate, as the growth of the debt of households and state and local governments declined modestly.

Implementation of Monetary Policy

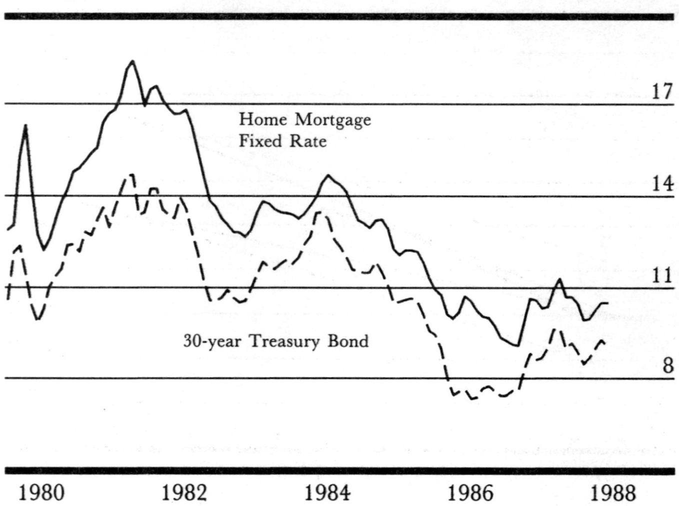
In conducting monetary policy, the Federal Reserve directed its operations during the first three months of 1988 at either maintaining or easing slightly the degree of reserve pressure that had prevailed since the October stock market collapse. Thereafter, the System moved in several steps to firm reserve positions.

In the aftermath of the stock market crash last October, the System's procedures were modified by placing greater emphasis on money market conditions and less on bank reserve positions in carrying out day-to-day open market operations. In doing so, it was neither the Committee's intention to alter its operating procedures permanently nor to ignore bank reserve positions completely. Rather, the thrust of the modification was to permit greater flexibility in System operations in light of the volatility and fragility characterizing financial markets at that time. During this period, it was considered important to assure the markets of the System's intention to provide adequate liquidity, and it was feared that

Short-term Interest Rates



Long-term Interest Rates



Note: Last observation is for June 1988.

significant variation in money market conditions could add to the unusual uncertainties already in the markets.

As markets exhibited signs of increased stability this year, the Committee responded by gradually placing greater emphasis on reserve positions in conducting System operations, allowing money markets to respond more sensitively to changing economic circumstances. The transition back to the pre-October approach was completed in the spring.

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

Period		M1	M2	M3	Domestic Nonfinancial Debt
Fourth quarter 1987 to second quarter 1988[e]		5.0	7.4	7.1	8.5
Fourth quarter 1987 to June 1988[e]		5.1	7.1	7.0	8.5
Fourth quarter to fourth quarter	1979	7.7	8.2	10.4	12.3
	1980	7.5	8.9	9.5	9.6
	1981	5.2 (2.5)*	9.3	12.3	10.0
	1982	8.7	9.1	9.9	8.9
	1983	10.2	12.1	9.8	11.3
	1984	5.3	7.6	10.4	14.2
	1985	12.0	8.9	7.7	13.3
	1986	15.6	9.4	9.1	13.3
	1987	6.2	4.0	5.4	9.6
Quarterly average 1987	Q1	13.2	6.5	6.5	10.5
	Q2	6.6	2.7	4.6	8.6
	Q3	0.8	2.8	4.5	7.9
	Q4	3.9	3.9	5.4	10.1
Quarterly average 1988	Q1	3.8	6.7	7.0	8.4
	Q2[e]	6.1	7.9	7.1	8.3

e—estimated

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

The Stock Market

The collapse of equity prices last October heightened public concerns about the volatility of stock prices and the fragility of financial institutions and markets. These concerns became the subject of studies by a Presidential commission, governmental agencies, and the securities industry. Recommendations from these groups and from a follow-up Presidential working group focused on ways to avoid excessive stock price volatility and to strengthen the ability of markets and related systems to deal with large price movements. Progress has been made in this regard, with steps having been taken by market participants to address some of the problems revealed by the market break in clearing and settlement systems. Additional steps have been taken to coordinate trading halts triggered by extreme price moves and to strengthen capital positions of specialists and other market makers.

In considering the possibility of future regulatory action in this sphere, it is noteworthy that the stock market break has not been followed by any major aftershocks. In part, this reflects the basic resilience in this period of the economy and financial markets. In addition, it attests to the general adequacy of the current regulatory framework and monetary policy institutions in cushioning financial disturbances, so that they do not spread to the economy as a whole. Thus, while the additional steps initiated by private entities to strengthen market mechanisms certainly are desirable, a major extension of the governmental regulatory apparatus does not seem necessary.

Definitions

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, including an appendix on the monetary base, is available from Publication Services, Federal Reserve Board, Washington, D.C. 20551

FRB14—48000—0788

1988

MONETARY POLICY OBJECTIVES

Testimony of Alan Greenspan, Chairman,
Board of Governors of the Federal Reserve System

July 13, 1988

Testimony of Alan Greenspan Chairman, Federal Reserve Board

Mr. Chairman, and members of the Committee, I appreciate this opportunity to review with you recent and prospective monetary policy and the economic outlook. I would also like to provide a broader perspective by discussing in some detail our nation's longer-term economic objectives, the overall strategy for fiscal and monetary policies needed to reach those objectives, and the appropriate tactics for implementing monetary policy within that strategic framework.

The Economic Setting and Monetary Policy So Far in 1988

The macroeconomic setting for monetary policy has changed in some notable respects since I testified last February. At that time, the full after-effects of the stock market plunge on spending and financial markets were still unclear. While most Federal Open Market Committee members were forecasting moderate growth, in view of rapid inventory building and some signs of a weakening of labor demand, the possibility of a decline in economic activity could not be ruled out. To guard against this outcome, in the context of a firmer dollar on exchange markets, the Federal Reserve undertook a further modest easing of reserve pressures in late January, which augmented the more substantial easing following October 19. Short-term interest rates came down another notch, and with a delay helped to push the monetary aggregates higher within their targeted annual ranges.

In the event, the economy proved remarkably resilient to the loss of stock market wealth. Economic growth remained vigorous through the first half of the year. Continuing brisk advances in exports, together with moderating growth in imports, supported expansion in output, especially in manufacturing. Some strengthening also was evident in business outlays for equipment, especially computers, and consumer purchases of durables, including autos.

Financial markets also returned to more normal functioning. Although trading volumes did not regain pre-crash levels in many markets, price volatility diminished somewhat and quality differentials stayed considerably narrower than in the immediate aftermath of the stock market plunge. In response, the Federal Reserve gradually was able to restore its standard procedure of gearing open market operations to the intended pressure on reserve positions of depository institutions. We thereby discontinued the procedure of reacting primarily to day-to-day variations in money market interest rates that had been adopted right after the stock market break.

As the risks of faltering economic expansion and further financial market disruptions diminished, the dangers of intensified inflationary pressures reemerged. Utilization of labor and capital reached the highest levels in many years, and hints of acceleration began to crop up in wage and price data. Strong gains in payroll employment that continued through the spring combined with slower growth in the labor force to lower the unemployment rate by about 1/4 percentage point, even before the strong labor market report for June; the industrial capacity utilization rate moved up as well. In part reflecting the payroll tax increase, broad measures of hourly compensation picked up somewhat in the first quarter. Prices for a wide range of domestic and imported industrial materials and supplies rose even more steeply than last year. Finished goods price inflation has not reflected this step-up in price increases for intermediate goods, in part as productivity gains kept unit labor costs under control. Even so, continued increases in materials prices at the recent pace were seen as pointing to a potential intensification in inflation more generally, since based on historical experience, such increases have tended to show through to finished good prices.

In these circumstances, the Federal Reserve was well aware that it should not fall behind in establishing enough monetary restraint to effectively resist these inflationary tendencies. The System took a succession of restraining steps from late March through late June. The shortest-term interest rates gradually rose to levels now around highs reached last fall. Responding as well to the unwinding of a tax-related buildup in liquid balances, M2 and M3 growth slowed noticeably.

In contrast to the shortest-maturity interest rates, long-term bond and mortgage rates, though also above February lows, still remain well below last fall's peaks. The timely tightening of monetary policy this spring, along with perceptions of better prospects for the dollar in foreign exchange markets in light of the narrowing in our trade deficit, seemed to improve market confidence that inflationary excesses would be avoided. Both bond prices and the dollar rallied in June despite increases in interest rates in several major foreign countries and jumps in some agricultural prices resulting from the drought in important growing areas.

The Economic Outlook and Monetary Policy through 1989

The monetary actions of the first half of the year were undertaken so that economic expansion could be maintained, recognizing that to do so, additional price pressures could not be permitted to build and progress toward external balance had to be sustained. The projections of FOMC members and nonvoting presidents indicate that they do expect economic growth to continue, and inflation to be contained.

The 2¾ to 3 percent central tendency of FOMC members' expectations for real GNP growth over the four quarters of this year implies a deceleration over the rest of the year to a pace more in line with their expected 2 to 2½ percent real growth over 1989 and with the long-run potential of the economy. The drought will reduce farm output for a time, and it is important that nonfarm inventory accumulation slow before long, if we are to avoid a troublesome imbalance. Still, further gains in our international trade position should continue to provide a major stimulus to real GNP growth through next year, reflecting the lagged effects of the decline in the exchange value of the dollar through the end of last year. Although the month-to-month pattern in our trade deficit can be expected to be erratic, the improvement in the external sector on balance over time is expected to replace much of the reduced expansion in domestic final demands from our consumer, business, and government sectors.

Employment growth is anticipated to be substantial, though some updrift in the unemployment rate may occur over the next year and a half. Capacity utilization could well top out soon, as growth in demands for manufactured goods slows to match that of capacity.

Considering the already limited slack in available labor and capital resources, a leveling of the unemployment and capacity utilization rates is essential if more intense inflationary pressures are to be avoided in the period ahead. Otherwise, aggregate demand would continue growing at an unsustainable pace and would soon begin to create a destabilizing inflationary climate. Supply conditions for materials and labor would tighten further and costs would start to rise more rapidly; businesses would attempt to recoup profit margins with further price hikes on final goods and services. These faster price rises would, in turn, foster an inflationary psychology, cut into workers' real purchasing power, and prompt an attempted further catchup of wages, setting in motion a dynamic process in which neither workers nor businesses would benefit. The hard-won gains in our international competitiveness would be eroded, with feedback effects depressing the exchange value of the dollar. Excessive domestic demands and inflation pressures in this country, with its sizable external deficit, would be disruptive to the ongoing international adjustment of trade and payments imbalances.

Not only the reduced slack in the economy but also several prospective adjustments in relative prices have accentuated inflation dangers. One is the upward movement of import prices relative to domestic prices, which is a necessary part of the process of adjustment to large imbalances in international trade and payments. Another is the recent drought-related increases in grain and soybean prices. It is essential that we keep these processes confined to a one-time adjustment in the level of prices and not let them spill over to a sustained higher rate of increase in wages and prices. Elevated import and farm prices must be prevented from engendering expectations of higher general inflation, with feedback effects on labor costs. A more serious long-run threat to price stability could come from government actions that introduced structural rigidities and increased costs of production. Protectionist legislation, inordinate hikes in the minimum wage, and other mandated programs that would impose costs on U.S. producers would adversely affect their efficiency and international competitiveness.

The costs to our economy and society of allowing a more intense inflationary process to become entrenched are serious. As the experience in the past two decades has clearly shown, accelerating wages and prices would have to be countered later by quite restrictive policies, with unavoidably adverse implications for production and employment. The financial health of many individual and business debtors, as well as of some of their creditors, then would be threatened. The long-run costs of a return to higher inflation and the risks of this occurring under current circumstances are sufficiently great, that Federal Reserve policy at this juncture might be well advised to err more on the side of restrictiveness rather than of stimulus.

We believe that monetary policy actions to date, together with the fiscal restraint embodied in last fall's agreement between the Congress and the administration, have set the stage for containing inflation through next year. The central tendency of FOMC members' expectations for inflation in the GNP deflator ranges from 3 to 3¾ percent over this year and 3 to 4½ percent next year. But in one sense the GNP deflator understates this year's rate of inflation, and the comparison with next year overstates the pick-up. The deflator represents the average price of final goods and services produced in the United States, or equivalently domestic value added, using current quantity weights. This measure was artificially held down in the first quarter by a shift in the composition of output, especially by the surge in sales of computers whose prices have dropped sharply since the 1982 base year used for constructing the deflator. Indeed, if the deflator were indexed with a 1987 base year, it would have risen appreciably faster in the first quarter.

Another understatement of inflation in the deflator this year arises from its exclusion of imported goods, which are not directly encompassed because they are produced abroad. In part because import prices have continued to rise significantly faster than prices of domestically produced goods, consumer price indexes have increased more than the GNP deflator.

The FOMC believes that efforts to contain inflation pressures and sustain the economic expansion would be fostered by growth of the monetary aggregates over 1988 well within their reaffirmed 4 to 8 percent annual ranges, followed by some slowing in money growth over the course of next year. M2 should move close to the midpoint of its range by late 1988, if depositors react as expected to the greater attractiveness of market instruments compared with liquid money balances that was brought about by recent increases in short-term market rates relative to deposit rates. M3 could end the year somewhat above its midpoint, though comfortably within its range, if depository institutions retain their recent share of overall credit expansion. The debt of nonfinancial sectors, which so far this year has been near the midpoint of its reaffirmed 7 to 11 percent monitoring range, is anticipated to post similar growth through year-end.

For 1989, the FOMC has underscored its intention to encourage progress toward price stability over time by lowering its tentative ranges for money and debt. We have preliminarily reduced the growth range for M2 by 1 full percentage point, to 3 to 7 percent; last February, the FOMC also had reduced the midpoint of the 1988 range for M2 by 1 percentage point from that for 1987. We have adjusted the tentative 1989 range for M3 downward by 1/2 percentage point, to 3½ to 7½ percent. This configuration is consistent with the observed tendency for M3 velocity over time to fall relative to the velocity of M2; over the last decade, the Federal Reserve's ranges frequently allowed for faster growth of M3 than of M2. The monitoring range for domestic nonfinancial debt for 1989 also has been lowered 1/2 percentage point to a tentative 6½ to 10½ percent.

The specific ranges chosen for 1989 are, as usual, provisional, and the FOMC will review them carefully next February, in light of intervening developments. Anticipating today how the outlook for the economy in 1989 will appear next February is difficult, and a major reassessment of that outlook would have implications for appropriate money growth ranges for that year. Unexpectedly strong or weak economic expansion or inflation pressures over the next six months also could have implications for the behavior of interest rates and their prospects for 1989. The sensitivity of the monetary aggregates to movements in market interest rates means that the appropriate growth next year in M2, M3, and debt could seem different next February than now, necessitating a revision in the annual growth ranges. As the aggregates have become more responsive to interest rate changes in the 1980s, judgments about possible ranges for the next year necessarily have become even more tentative and subject to revision.

The Persistent U.S. External and Fiscal Imbalances

Despite the changes in the economic setting over the last six months, other features of the macroeconomic landscape remain much the same. Most notable are the continuing massive deficits in our external payments and internal fiscal accounts. As a nation, we still are living well beyond our means; we consume much more of the world's goods and services each year than we produce. Our current account deficit indicates how much more deeply in debt to the rest of the world we are sliding each year.

The consequence of this external imbalance will be a steady expansion in our external debt burden in the years ahead. No household or business can expect to have an inexhaustible credit line with borrowing terms that stay the same as its debt mounts relative to its wealth and income. Nor can we as a nation expect our foreign indebtedness to grow indefinitely relative to our servicing capacity without additional inducements to foreigners to acquire dollar assets—either higher real interest returns, or a cheaper real foreign exchange value for dollar assets, or both. To be sure, such changes in market incentives would have self-correcting effects over time in reducing the imbalance between our domestic spending and income. Higher real interest rates would curtail domestic investment and other spending. A lower real value of the dollar would make U.S. goods and services relatively less expensive to both U.S. and foreign residents, damping our spending on imports out of U.S. income and boosting our exports.

But simply sitting back and allowing such a self-correction to take place is not a workable policy alternative. Trying to follow such a course could have severe drawbacks now that our economy is operating close to effective capacity and potential inflationary pressures are on the horizon. The time is hardly propitious to discourage investment in needed plant and equipment, to add further impulses for import price hikes on top of the upward tendencies already in the making, or to push our export industries as well as import-competing industries to their capacity limits.

Fortunately, we have a better choice for righting the imbalance between domestic spending and income—one over which we have direct control. That is to resume reducing substantially the still massive federal budget deficit, which remains the most important source of dissaving in our economy. The fall in the dollar we have already experienced over the last few years, even allowing for the dollar's appreciation from the lows reached at the end of last year, has set in motion forces that should continue to narrow our trade and current account deficits in the years ahead. The associated loss of foreign-funded domestic investment is likely to adversely affect overall investment unless it can be replaced by greater domestic investment financed by domestic saving. A sharp contraction in the federal deficit appears to be the only assured source of augmented domestic net saving. Such a fiscal cutback should help counter future tendencies for further increases in U.S. interest rates and declines in the dollar, partly by instilling confidence on the part of international investors in the resolve of the United States to address its economic problems.

Fiscal restraint in the years ahead would assist in making room for the needed diversion of more of our productive resources to meeting demands from abroad. Domestic demands will have to continue growing more slowly than our productive capacity, as seems to have been the case so far this year, if net exports are to expand further without resulting in an inflationary overheating of the economy. Absent this fiscal restraint, higher interest rates would become the only channel for damping domestic demands if they were becoming excessive. If a renewed decline in the dollar were adding further inflationary stimulus at the same time, upward pressures on interest rates would be even more likely. The restrictive impact would be felt most by the interest-sensitive sectors—homebuilding, business fixed investment, and consumer durables.

In terms of federal deficit reduction, the schedule under the Gramm-Rudman-Hollings law is a good baseline for a multi-year strategy, and I trust the Congress will stick with it. But we should go further. Ideally, we should be aiming ultimately at a federal budget surplus, so that government saving could supplement private domestic saving in financing additional domestic investment. Historically, the United States was not a low saving, low investing economy. From the post-Civil War period through the 1920s, the United States consistently saved more as a fraction of GNP than Japan and Germany, and we saved much more as a share of GNP then than we have since the end of World War II. A turnaround in our current domestic saving performance is essential to a smooth reduction in our dependence on foreign saving, and the federal government should take the lead.

It is also apparent that redressing our external imbalances must encompass cooperative policies with our trading partners. These include both the established industrial powers, the newly industrialized economies, and the developing countries, whose debt problems must be worked through as part of the international adjustment process.

This is the strategy that U.S. fiscal policy as well as economic policies abroad should follow in most effectively promoting our shared economic objectives. The strategic role of U.S. monetary policy is implied by a clear statement of what those ultimate objectives are. We should not be satisfied unless the U.S. economy is operating at high employment with a sustainable external position and above all stable prices.

High employment is consistent with steadily rising nominal wages and real wages growing in line with productivity gains. Some frictional unemployment will exist in a dynamic labor market, reflecting the process of matching available workers with available jobs. But every effort should be made to minimize both impediments that contribute to structural unemployment and deviations of real economic growth from the economy's potential that cause cyclical unemployment.

By a sustainable external position, I am referring to a situation in which our foreign indebtedness is not persistently growing faster than our capacity to service it out of national income. Our international payments need not be in exact balance from one year to the next, and the exchange value of the dollar need not be perfectly stable, but wide swings in the dollar, and boom and bust cycles in our export and import-competing industries, should be avoided.

By price stability, I mean a situation in which households and businesses in making their saving and investment decisions can safely ignore the possibility of sustained, generalized price increases or decreases. Prices of individual goods and services, of course, would still vary to equilibrate the various markets in our complex national and world economy, and particular price indexes could still show transitory movements. A small persistent rise in some of the indexes would be tolerable, given the inadequate adjustment for trends in quality improvement and the tendency for spending to shift toward goods that have become relatively cheap. But essentially the average of all prices would exhibit no trend over time. Price movements in these circumstances would reflect relative scarcities of goods, and private decision-makers could focus their concerns on adjusting production and consumption patterns appropriately to changing individual prices, without being misled by generalized inflationary or deflationary price movements.

The strategy for monetary policy needs to be centered on making further progress toward and ultimately reaching stable prices. Price stability is a prerequisite for achieving the maximum economic expansion consistent with a sustainable external balance at high employment. Price stability reduces uncertainty and risk in a critical area of economic decisionmaking by households and businesses. In the process of fostering price stability, monetary policy also would have to bear much of the burden for countering any pronounced cyclical instability in the economy, especially if fiscal policy is following a program for multi-year reductions in the federal budget deficit. While recognizing the self-correcting nature of some macroeconomic disturbances, monetary policy does have a role to play over time in guiding aggregate demand into line with the economy's potential to produce. This may involve providing a counterweight to major, sustained cyclical tendencies in private spending, though we can not be overconfident in our ability to identify such tendencies and to determine exactly the appropriate policy response. In this regard, it seems worthwhile for me to offer some thoughts on the approach the Federal Reserve should take in implementing this longer-term strategy for monetary policy.

The Appropriate Tactics for Monetary Policy

For better or worse, our economy is enormously complex, the relationships among macroeconomic variables are imperfectly understood, and as a consequence economic forecasting is an uncertain endeavor. Nonetheless, the forecasting exercise can aid policymaking by helping to refine the boundaries of the likely economic consequences of our policy stance. But forecasts will often go astray to a greater or lesser degree and monetary policy has to remain flexible to respond to unexpected developments.

A perfectly flexible monetary policy, however, without any guideposts to steer by, can risk losing sight of the ultimate goal of price stability. In this connection, the requirement under the Humphrey-Hawkins Act for the Federal Reserve to announce its objectives and plans for growth of money and credit aggregates is a very useful device for calibrating prospective monetary policy. The announcement of ranges for the monetary aggregates represents a way for the Federal Reserve to communicate its policy intentions to the Congress and the public. And the undisputed long-run relation between money growth and inflation means that trend growth rates in the monetary aggregates provide useful checks on the thrust of monetary policy over time. It is clear to all observers that the monetary ranges will have to be brought down further in the future if price stability is to be achieved and then maintained.

But, in a shorter-run countercyclical context, monetary aggregates have drawbacks as rigid guides to monetary policy implementation. As I discussed in some detail in my February testimony, financial innovation and deregulation in the 1980s have altered the structure of deposits, lessened the predictability of the demands for the aggregates, and made the velocities of M1 and probably M2 over periods of a year or so more sensitive to movements in market interest rates. Movements in short-term market rates relative to sluggishly adjusting deposit rates can result in large percentage changes in the opportunity costs of holding liquid monetary assets. Depositor responses can induce divergent growth between money and nominal GNP for a time. I might add that it was partly these considerations that led the FOMC to retain the wider four percentage point ranges for money and credit growth for this year and next.

Nonetheless, the demonstrated long-run connection of money and prices overshadows the problems of interpreting shorter-run swings in money growth. I certainly don't want to leave the impression that the aggregates have little utility in implementing monetary policy. They have an important role, and it is quite possible that their importance will grow in the years ahead. Currently, the FOMC keeps M2 and M3 under careful scrutiny, and judges their actual movements relative to assessments of their appropriate growth at any particular time. In this context, these aggregates are among the indicators influencing adjustments to the stance of policy, both at regular FOMC meetings and between meetings, as the FOMC's directive to the Federal Reserve Bank of New York's Trading Desk indicates. The FOMC also regularly monitors a variety of other monetary aggregates. At times in recent years, we have intensively examined the properties of several alternative measures, and reported the results to the Congress. These measures have included M1, M1-A (M1 less NOW accounts), monetary indexes, and most recently the monetary base.

An analysis of the monetary base appears as an appendix to the Board's Humphrey-Hawkins report. This aggregate, essentially the sum of currency and reserves, did not escape the sharp velocity declines of other money measures earlier in the 1980s. Its velocity behavior stemmed from relatively strong growth in transactions deposits compared with GNP, which was mirrored in the reserve component of the base. In this sense, some of the problems plaguing M1 also have shown through to the base, though in somewhat muted form. Moreover, the three-quarters share of currency in the base raises some question about the reliability of its link to spending. The high level of currency holdings—$825 per man, woman and child living in the United States—suggests that vast, indeterminate amounts of U.S. currency circulate or are hoarded beyond our borders. Indeed, over the last year and one half, currency has grown noticeably faster than would have been expected from its historical relationships with U.S. spending and interest rates.

Although the monetary base has exhibited some useful properties over the last three decades as a whole, the FOMC's view is that its behavior has not consistently added to the information provided by the broader aggregates, M2 and M3. The Committee accordingly has decided not to establish a range for this aggregate, although it has requested staff to intensify research into the ability of various monetary measures to indicate long-run price trends.

Because the Federal Reserve cannot reliably take its cue for shorter-run operations solely from the signals being given by any or all of the monetary aggregates, we have little alternative but to interpret the behavior of a variety of economic and financial indicators. They can suggest the likely future course of the economy given the current stance of monetary policy.

Judgments about the balance of various risks to the economic outlook need to adapt over time to the shifting weight of incoming evidence; this point is well exemplified so far this year, as noted earlier. The Federal Reserve must be willing to adjust its instruments fairly flexibly as these judgments evolve; we must not hesitate to reverse course occasionally if warranted by new developments. To be sure, we should not overreact to every bit of new information, because the frequent observations for a variety of economic statistics are subject to considerable transitory "noise". But we need to be willing to respond to indications of changing underlying economic trends, without losing sight of the ultimate policy objectives.

To the extent that the underlying economic trends are judged to be deviating from a path consistent with reaching the ultimate objectives, the Federal Reserve would need to make "mid-course" policy corrections. Such deviations from the appropriate direction for the economy will be inevitable, given the delayed and imperfectly predictable nature of the effects of previous policy actions. Numerous unforeseen forces not related to monetary policy will continue to buffet the economy. The limits of monetary policy in short-run stabilization need to be borne in mind. The business cycle cannot be repealed, but I believe it can be significantly damped by appropriate policy action. Price stability cannot be dictated by fiat, but governmental decision-makers can establish the conditions needed to approach this goal over the next several years.