

Midyear Review of the Federal Reserve Board

1989
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July 20, 1989

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

Mr. Chairman and Members of the Committee: I appreciate this opportunity to appear before you in connection with the Federal Reserve's semiannual Monetary Policy Report to Congress. In my prepared remarks today I will adhere closely to the matter at hand—that is, monetary policy and the state of the nation's economy.

Economic and Monetary Developments Thus Far in 1989

Over the course of this year, the contours of the broad economic setting have changed. As a consequence, the stance of monetary policy also has shifted somewhat, although the fundamental objective of our policy has not. That objective remains to maximize sustainable economic growth, which in turn requires the achievement of price stability over time.

Early in the year, the Federal Reserve continued on the path toward increased restraint upon which it had embarked in the spring of 1988. At the time of our report to Congress in February of this year, I characterized the economy as strong, with the risks on the side of a further intensifying of price pressures. Labor markets had been tightening noticeably, heightening concerns that inflationary pressures might be building. Moreover, increases in food and crude oil prices were raising the major inflation indexes.

In view of the dimensions of the inflation threat, the Federal Reserve tightened policy further early this year. Additional reserve restraint was applied through open market operations, and the discount rate was raised $\frac{1}{2}$ percentage point. The determination to resist any pickup in inflation also motivated the decision of the Federal Open Market Committee at its February meeting to lower the ranges for money and credit growth for 1989. This marked the third consecutive year in which the target ranges were reduced, and it underscored our commitment to achieving price stability over time.

Reflecting the economy's apparent strength and the tighter stance of policy, interest rates rose during the first quarter. Short-term market rates increased around 1 percentage point over the quarter, leaving them up more than 3 points from a year earlier, but long-term rates held relatively steady. The year-long rise in short-term rates had a marked impact on growth of the monetary aggregates, restraining the demand for money as funds flowed instead into higher-yielding market instruments.

By the beginning of the second quarter, the outlook for spending and prices was becoming more mixed. Scattered indications of an emerging softening in economic activity began to appear, prompting market interest rates to pull back. Rates continued to fall as a variety of factors pointed to some lessening of price pressures in the period ahead. In particular, money growth weakened further, the underlying trend in inflation appeared to be less severe than markets had feared, the dollar continued to climb, and domestic demand slackened. Against this background, the Federal Reserve eased reserve conditions, first in early June and again in early July. By mid-July, most short-term market rates had fallen to a bit below their year-end levels, and long-term interest rates were down as much as a full point, to their lowest levels in more than two years.

Economic activity apparently grew in the first half of this year at a rate somewhat below that of potential GNP. This stands in sharp contrast to the performance of the preceding two years during which growth proceeded at a pace that placed increasing pressures on labor and capital resources. Job creation has remained the hallmark of the current expansion, however. Even with the more moderate pace of economic growth in the first half of this year, nearly 1 ½ million new jobs were added to payrolls. And this occurred apparently without triggering an acceleration in wages.

Prices did accelerate in the first six months of this year, but most of the increase may be transitory, related to supply conditions in food and petroleum markets. After a gradual pickup over the preceding two years, price inflation outside of food and energy held near its 1988 pace.

Excluding food and energy is one traditional way of estimating the “underlying” rate of inflation. Although there is some logic in abstracting from these prices, which are quite volatile and can be dominated over the short run by supply disturbances, this approach is incomplete. An alternate picture of near-term price-setting behavior can be gleaned by examining the components of prices, that is, the cost pressures facing firms and the behavior of their profits. Such an analysis reveals that, in manufacturing, much of the pickup in inflation thus far in 1989 is accounted for by higher unit energy and labor costs. The runup in world crude oil prices, which reflected a series of production accidents this spring as well as a degree of output restraint on the part of some OPEC oil producers, is the main reason for the increase in energy costs.

In contrast, movements in hourly compensation appear to have been quite moderate in the first half of this year, and the acceleration in unit labor costs largely reflected slower growth in productivity. Such a deceleration in productivity is typical as the pace of economic activity slows. But, given the relatively high levels of resource utilization, it also is possible that firms were forced to draw on less skilled workers

than was the case earlier in the expansion. A significant moderation in the unit cost of imported materials, likely reflecting the higher value of the dollar on foreign exchange markets, provided a notable offset to these cost pressures. On balance, it appears that firms have continued to experience upward pressures on costs. The intensity of these pressures as related to energy inputs may well diminish in coming months, but it remains to be seen how other elements of the cost structure will evolve.

This approach, while helpful in understanding the interaction of prices and costs, does not tell us how an inflation cycle begins or why it may persist. Short-run inflation impulses can originate from a variety of sources, on both the demand and the supply sides of the economy. But over longer periods of time, inflation cannot persist without at least passive support from the monetary authorities.

The strength of the inflation pressures in 1988 and into 1989 was, of course, the motive for the progressive tightening of policy that the Federal Reserve undertook over that period. And the outlook for some reduction in these pressures owes in part to that policy restraint. The associated rise in market interest rates, beginning early last year, opened up wide “opportunity” costs of holding money assets and resulted in a sharp slowing of money growth. This was especially the case for liquid deposits, whose rates were adjusted upward only very sluggishly, providing depositors with strong incentives to economize on balances.

In addition to the effect of interest rates, several special factors played a role in slowing money growth and boosting velocity—that is, the ratio of nominal GNP to money. Probably the most important of these was the unexpectedly large size of personal tax liabilities in April. Many individuals evidently were surprised by the size of their liabilities, and drew down their money balances below normal levels to make the required payments. As the IRS cashed those checks, M2 registered outright declines.

The difficulties of the thrift industry also may have affected M2 growth. Late last year, as public attention increasingly focused on the financial condition of the industry and its insurance fund, FSLIC-insured institutions began to lose deposits at a significant rate. These deposit withdrawals were particularly strong in the first quarter of this year, and while most of the funds apparently were repositioned within M2—at commercial banks or money funds—this factor likely also had some damping effect on that aggregate.

More recently, growth of the broader monetary aggregates has picked up markedly. The restraint imposed by the earlier rise in market interest rates is fading, and households appear to be rebuilding their tax-depleted balances. As of May, M2 had risen at just a 1 percent rate from its fourth-quarter base, but the 6¾ percent rate of growth in June lifted the year-to-date increase to around a 2 percent rate, still somewhat below its 3 to 7 percent annual target cone. M3 rose at a 3½ percent rate through June, at the lower end of its range. The latest data on these aggregates suggest that relatively rapid expansion has continued into July.

M1, which is the most interest-sensitive of the monetary aggregates, declined at a 3½ percent rate through June. The unusual drop in M1 stemmed from sizable declines in NOW accounts and demand deposits. NOW accounts were reduced both by the large personal tax payments this spring and by the high level of interest rates, which drew savings-type balances instead toward market instruments or other types of accounts whose offering rates adjusted upward more quickly. The decline in demand deposits was related in part to a reduction in balances that businesses are required to hold to compensate their banks for various services; for a set amount of services, higher market rates translate into lower required balances.

Monetary Policy and the Economy into 1990

Looking ahead at the remainder of 1989 and into 1990, recent developments suggest that the balance of risks may have shifted somewhat away from greater inflation. Even so, inflation remains high—clearly above our objective. Any inflation that persists will hinder the economy's ability to perform at peak efficiency and to create jobs. Consequently, monetary policy will need to continue to focus on laying the groundwork for gradual progress toward price stability. Such an outcome need not imply a marked downturn in the economy, and policy will have to be alert to any emerging indications of a cumulative weakening of activity. However, progress on inflation and optimum growth over time also require that our productive resources not be under such pressures that their prices continue to rise without abating. In light of historical patterns of labor and capital growth and productivity, this progress very likely will be associated with a more moderate, and hence sustainable, expansion in demand than we experienced in 1987 and 1988.

At its meeting earlier this month, the Federal Open Market Committee determined that a combination of continued economic growth and reduced pressures on prices would be promoted by growth of money and debt in 1989 within the annual ranges that were set in February. Moreover, it tentatively decided to maintain these same ranges through 1990.

The specified ranges, both for this year and next, retain the 4-percentage-point width first instituted for the broader aggregates in 1988. Considerable uncertainties about the behavior of money and credit remain, and the greater breadth allows for a range of paths for these aggregates as financial and economic developments may warrant. Uncertainties about the link between the narrow transactions aggregate, M1, and the economy have, if anything, increased, and the Committee once again did not specify a range for this aggregate.

In view of the apparent variability, particularly over the short run, in the relationships between the monetary aggregates and the economy, policy will continue to be carried out with attention to a wide range of economic and financial indicators. The complex nature of the economy and the chance of false signals demand that we cast our net broadly—gathering information on prices, real activity, financial and foreign exchange markets, and related data.

While the monetary aggregates may not be preeminent on this list, they always receive careful consideration in our policy decisions. This is especially true when they exhibit unusual strength or weakness relative to past patterns and relative to our announced ranges. Thus, the very sluggish growth in M2 for the year to date was an important influence in the decision to ease policy in June and again in July. Velocity may vary considerably over a few quarters, but the provision of liquidity, as measured by one or another of the monetary aggregates, is an important factor in the performance of the economy over the shorter run and over the long run broadly determines the rate of price increase.

Although M2 currently remains below its 1989 target cone, it has picked up substantially. The decline in interest rates in recent months, along with the continued growth of income, should provide support for that aggregate over the rest of the year, helping to lift it into the lower part of its target range. Growth in M2 likely will be augmented by a cessation of the special influences I noted earlier that depressed it in the first half of the year. In particular, we expect households to continue to rebuild their money balances after the tax-related drawdowns in April and May. Also, deposit withdrawals from thrift institutions have subsided, and enactment of legislation that restores full confidence in the industry would bode well for deposit flows into FSLIC-insured institutions.

Further steps in the resolution of the thrift industry difficulties also have implications for M3. With deposits flowing in again, thrifts will not have to rely so heavily on the Federal Home Loan Banks for their funding as they did earlier this year. Partly as a result, we expect M3 to strengthen from its rate of growth over the first half of the year, moving up into the middle of its target range by year-end.

Our outlook for debt growth foresees little change from the pace of the first two quarters. The broad credit measure that we monitor, the debt of domestic nonfinancial sectors, has grown at about an 8 percent rate this year, near the midpoint of its 6½ to 10½ percent range. We have little reason to expect its growth through the end of the year to be very different, implying some slowing from the pace of 1988. Nevertheless, the expansion of debt is likely to exceed nominal GNP growth again this year.

Growth of money and debt within the 1989 ranges is expected to be consistent with nominal GNP rising this year at a pace not too far from last year's increase, according to the projections of FOMC members and other presidents of Reserve Banks. These projections, however, incorporate somewhat more inflation and less real growth than we experienced in 1988. The central tendency of the projections of 2 to 2½ percent real GNP growth over the four quarters of this year implies continued moderate economic growth throughout the year. For the year as a whole, these projections anticipate that growth is likely to be strongest in the investment and export sectors of the economy, with expansion of consumer expenditures and government purchases rather subdued.

A sectoral pattern of growth such as this would in fact serve the nation's longer-term needs by contributing to a better external balance. Fundamentally, improvement in our international payments position requires productivity-enhancing investment and a higher national saving rate. In this regard the federal government can play a significant, positive role by reducing the budget deficit.

The outlook for inflation this year, as reflected in the central tendency of the projections expressed at the FOMC meeting, is for a 5 to 5½ percent increase in the consumer price index. A figure in this range would represent the highest annual inflation rate in the United States since 1981; this is a source of concern to the Federal Reserve. Yet this rate is below that experienced in the first six months. This implies a considerable slowing over the remainder of the year, reflecting earlier monetary policy restraint and a prospective moderation in food and energy prices.

Federal Reserve policy is focused on laying the groundwork for more definite progress in reducing inflation pressures in 1990, while continuing support for the economic expansion. The ranges provisionally established for growth of money and debt next year are consistent with these intentions. They allow for a noticeable pickup in money growth from that likely to prevail this year, should that be appropriate. If pressures on prices and in financial markets are less intense than in recent years, velocity would not be expected to continue to increase, and faster money growth, perhaps in the top half of the range, would be needed for a time to support economic growth. Conversely, if price pressures prove intractable, the ranges are low enough to permit the needed degree of monetary restraint.

Thus, although the 1990 ranges do not represent another step in the gradual, multiyear lowering of ranges, the Federal Reserve's intent to make further progress against inflation remains intact. Uncertainties about the outlook suggested a pause in the process of reducing the ranges; however, the Committee recognizes that our goal of price stability will require additional downward adjustments in these ranges over time. Of course, as we draw closer to 1990, the economic and financial conditions prevailing will become clearer, allowing us to approach our decisions on the ranges with more confidence. Hence, the current ranges for money and credit growth in 1990 should be viewed as very preliminary.

The economic projections for 1990 made by the governors and Reserve Bank presidents center in a range of 1½ to 2 percent real GNP growth and 4½ to 5 percent inflation for next year. Naturally, as I've already noted, there are considerable uncertainties surrounding forecasts for 1990. In particular, developments in the external sector will depend in part on economic activity abroad, as well as on the efforts of U.S. firms to become more competitive in world markets. Domestically, performance will be affected by a large number of influences, including importantly the budget deficit.

Monetary Policy in Perspective

The Federal Reserve is committed to doing its utmost to ensure prosperity and rising standards of living over the long run. Given the powers and responsibilities of the central bank, that means most importantly maintaining confidence in our currency by maintaining its purchasing power. The principal role of monetary policy is to provide a stable backdrop against which economic decisions can be made. A stable, predictable price environment is essential to ensure that resources can be put to their best use and ample investment for the future can be made.

In the long run, the link between money and prices is unassailable. That link is central to the mission of the Federal Reserve, for it reminds us that without the acquiescence of the central bank, inflation cannot take root. Ultimately, the monetary authorities must face the responsibility for lasting price trends. While oil price shocks, droughts, higher taxes, or new government regulations may boost broad price indexes at one time or another, sustained inflation requires at least the forbearance of the central bank. Moreover, as many nations have learned, inflation can be corrosive. As it accelerates, the signals of the market system lose their value, financial assets lose their worth, and economic progress becomes impossible.

Thankfully, this bleak scenario is not one that we in the United States are confronting. We do, however, face a difficult balancing act. The economy has prospered in recent years: the economic expansion has proven exceptionally durable, employment has surpassed all but the most optimistic expectations, and the underlying inflation rate, after coming down quickly in the early 1980s, has accelerated only modestly. But now signs of softness in the economy have shown up.

Accordingly, it is prudent for the Federal Reserve to recognize the risk that such softness conceivably could cumulate and deepen, resulting in a substantial downturn in activity. We also recognize, however, that a degree of slack in labor and product markets will ease the inflationary pressures that have built up. So our policy, under current circumstances, is not oriented toward avoiding a slowdown in demand, for a slowing from the unsustainable rates of 1987 and 1988 is probably unavoidable. Rather what we seek to avoid is an unnecessary and destructive recession.

The balance that we must strike is to support moderate growth of demand in the near term, while concurrently progressing toward our longer-run goal of a stable price level. Admittedly, the balance we are seeking is a delicate one. I wish I could say that the business cycle has been repealed. But some day, some event will end the extraordinary string of economic advances that has prevailed since late 1982. For example, an inadvertent, excess accumulation of inventories or an external supply shock could lead to a significant retrenchment in economic activity.

Moreover, I cannot rule out a policy mistake as the trigger for a downturn. We at the Federal Reserve might fail to restrain a speculative surge in the economy or fail to recognize that we were holding reserves too tight for too long. Given the lags in the effects of policy, forecasts inevitably are involved and thus errors inevitably arise. Our job is to keep such errors to an absolute minimum. An efficient policy is one that doesn't lose its bearings, that homes in on price stability over time, but that copes with and makes allowances for any unforeseen weakness in economic activity. It is such a policy that the Federal Reserve will endeavor to pursue.

1989
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

Section	Page
Monetary Policy and the Economic Outlook for 1989 and 1990	2
Monetary Policy for 1989 and 1990	2
Economic Projections for 1989 and 1990	3
The Performance of the Economy during the First Half of 1989	5
The External Sector	5
The Household Sector	6
The Business Sector	6
The Government Sector	7
Labor Markets	7
Price Developments	8
Monetary Policy and Financial Developments during the First Half of 1989	9
The Implementation of Monetary Policy	9
The Behavior of the Monetary Aggregates	10
Credit Flows	10

Monetary Policy and the Economic Outlook for 1989 and 1990

As 1989 began, a reduction in inflationary pressures appeared essential if the ongoing economic expansion was to be sustained. Monetary policy during 1988 had been directed toward reducing the risks of an escalation of inflation and inflationary expectations, but at the time of the Board's report to the Congress in February of this year, success in that effort seemed far from assured.

Indeed, among the data reported in the early part of 1989 were very large increases in the producer and consumer price indexes, reflecting not only the effects of run-ups in oil and agricultural commodity prices, but also broader inflationary developments, including unfavorable trends in unit labor costs over the preceding year. Under the circumstances, with pressures on productive resources still intense, monetary policy was tightened further. Reserve availability was curtailed through open market operations, and the discount rate was raised 1/2 percentage point in late February. In response to these policy actions, and to expectations that additional tightening moves might be needed, market interest rates climbed throughout the first quarter, and money growth was subdued.

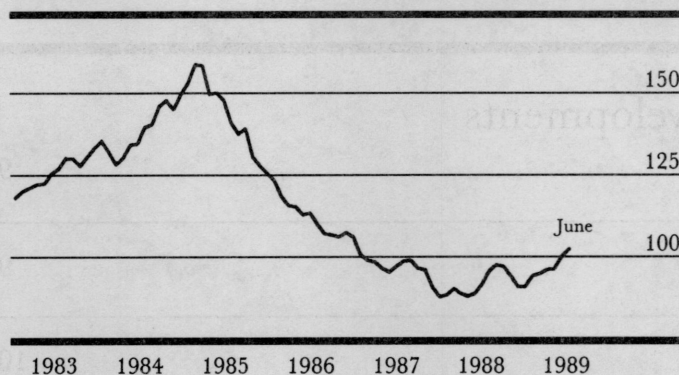
Over the course of the second quarter, a number of indicators suggested the emergence of conditions that were more conducive to a future easing of inflationary pressures. Growth of the monetary aggregates weakened further, with M2 running noticeably

below its target range for the year. Aggregate demand for goods and services moderated, reducing somewhat the strains on productive resources, especially in the industrial sector of the economy. The dollar exhibited considerable strength on the foreign exchange markets, portending a direct reduction in price pressures and slower growth in demands on domestic production capacity. Although the unemployment rate remained essentially unchanged in the neighborhood of 5 1/4 percent—the lowest level since the early 1970s—trends in wages and total compensation showed little, if any, further step-up, reflecting at least in part an awareness among workers and management of the need to contain costs in a highly competitive world economy. Meanwhile, prices of actively traded industrial commodities leveled out, enhancing the prospects of a broader slackening in the pace of inflation.

In this environment, interest rates turned down during the spring, as financial market participants responded not only to the better outlook for inflation but also in anticipation of an easing of monetary restraint by the Federal Reserve. The System began to provide reserves slightly more generously through open market operations at the beginning of June, and took an additional small easing step in early July. This helped bring about a further decline in market rates of interest, which by mid-July generally had more than retraced the increases that had occurred earlier in the year. Most short-term interest rates were down about 1/2 percentage point from their December levels, while long-term rates had fallen as much as 1 percentage point on balance.

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.

Monetary Policy for 1989 and 1990

In February, the Federal Open Market Committee (FOMC) specified a range for M2 growth in 1989 that was a full percentage point below that of 1988 and ranges for M3 and debt that were 1/2 percentage point below those of the prior year. This was the third consecutive year in which the ranges had been lowered.

In February, the Committee had anticipated relatively slow money growth over the first half of the year, because of the effects of the firming of policy through late 1988 and into 1989. In addition to the influence of the higher interest rates on desired hold-

Ranges of Growth for Monetary and Credit Aggregates¹

(Percent Change, Fourth Quarter to Fourth Quarter)

	1988	1989	Provisional for 1990
M2	4 to 8	3 to 7	3 to 7
M3	4 to 8	3½ to 7½	3½ to 7½
Debt	7 to 11	6½ to 10½	6½ to 10½

ings of money, however, several special factors—including the difficulties of the thrift industry and a drawdown of liquid assets to meet unusually large individual tax payments—appear to have further reduced money balances in the first half. These factors contributed to a substantial rise in velocity, the ratio of nominal GNP to the stock of money.

By June, money growth had picked up. Nonetheless, M2 ended the quarter just 2 percent at an annual rate above the fourth quarter of last year, compared with its 3 to 7 percent annual growth range. In June, M3 was at the lower end of its 3½ to 7½ percent annual range. The rate of expansion of domestic nonfinancial sector debt also slowed in the first half of this year compared with 1988, though by less than the monetary aggregates; debt has grown about 8 percent so far this year, near the middle of its 6½ to 10½ percent monitoring range.

At its meeting earlier this month, the Committee agreed to retain the current ranges for growth of money and debt in 1989. The Committee anticipates that by the fourth quarter all three aggregates will be well within those ranges. The more rapid growth in M2 and M3 already evident since mid-May is expected to extend through the second half. The recent declines in short-term market interest rates have made M2 holdings more attractive, tending to offset the restraining effects on M2 of previous interest rate increases. Domestic nonfinancial debt is likely to remain in the middle portion of its range through year-end.

For 1990, the Committee provisionally decided to use, for all three aggregates, the same growth ranges in force for 1989. The Committee recognized

that the economic and financial outlook over the next year and a half is uncertain; in particular, it is unclear at this juncture whether the velocities of M2 and M3 are more likely to trend higher or lower next year. Although the Committee's initial assessment is that growth of money and credit through 1990 within the bounds of the reduced ranges of this year likely would foster the slower inflation and sustained real economic expansion that it is seeking, it will reevaluate the ranges next February in light of the unfolding economic and financial situation. The outlook for spending, prices, and financial markets in 1990 should have clarified somewhat by then, as should the influence on monetary expansion of the ongoing resolution of thrift industry problems. For the long term, the Committee recognized that ultimate attainment of price stability will require that the ranges for money and credit growth be reduced further in future years.

Economic Projections for 1989 and 1990

Members of the Committee and other Reserve Bank presidents believe that the monetary ranges specified are consistent with some progress in reducing inflation, which likely will be associated in the near term with continuation of a slower pace of economic growth. The central tendency of the forecasts is for increases in real GNP of 2 to 2½ percent in 1989 and of 1½ to 2 percent in 1990.

The expected easing of pressures on resources should contribute to a damping of inflation in 1990, although the Board members and Reserve Bank presidents also are anticipating some near-term relief from the special problems that boosted prices in the first half of this year. More ample harvests later this year should result in more favorable behavior of food prices, and the recent peaking of crude oil prices suggests the likelihood of some softening in consumer energy prices. Thus, retail inflation should be considerably slower over the remainder of this year, and the central tendency of CPI forecasts for 1989 as a whole is 5 to 5½ percent—compared with the more than 6 percent rate observed through May. The forecasts for the CPI in 1990 center on 4½ to 5 percent.

In an environment of relatively slow overall growth, such as is expected by the FOMC members, some industries and regions are likely to experience setbacks, but major imbalances that could threaten the continuation of the economic expansion are not anticipated. In the household sector, growth of consumer purchases has been sluggish and may remain so for a while. Residential construction activity should pick up some in coming months.

The external sector represents an area of considerable uncertainty in the economic outlook for the next year and a half. Real net exports of goods and services increased earlier this year, but improvements may be more difficult to achieve in the period ahead as the effects of past depreciation of the dollar wear off and are offset by those associated with the more recent appreciation. In addition, the path of

exports will depend importantly on economic growth abroad, which may slow as a result of policy actions taken by some of our major trading partners to offset mounting inflationary pressures.

A key ingredient in maintaining a healthy pace of economic expansion is further progress in reducing the federal budget deficit. Taking the actions required to meet the Gramm-Rudman-Hollings targets on schedule will foster confidence in the U.S. economy, particularly among financial market participants. At the same time, reduced demands by the federal government for credit will free up the available supply to interest-sensitive private sectors, such as housing and business investment. The Committee thus views as highly encouraging the commitments expressed by the Congress and the Administration to begin soon to address the problems of meeting the fiscal 1991 budget target.

Economic Projections for 1989 and 1990

		FOMC Members and other FRB Presidents	Administration
1989		Range	Central Tendency
Percent change, fourth quarter to fourth quarter:	Nominal GNP	5 to 7¾	6 to 7
	Real GNP	1½ to 2¾	2 to 2½
	Consumer price index	4½ to 5¾	5 to 5½
Average level in the fourth quarter, percent:	Civilian unemployment rate	5 to 6	Around 5½
1990		Range	Central Tendency
Percent change, fourth quarter to fourth quarter:	Nominal GNP	4¼ to 7½	5½ to 6¾
	Real GNP	1 to 2½	1½ to 2
	Consumer price index	3 to 5¾	4½ to 5
Average level in the fourth quarter, percent:	Civilian unemployment rate	5 to 6½	5½ to 6

1. CPI-W. FOMC forecasts are for CPI-U.

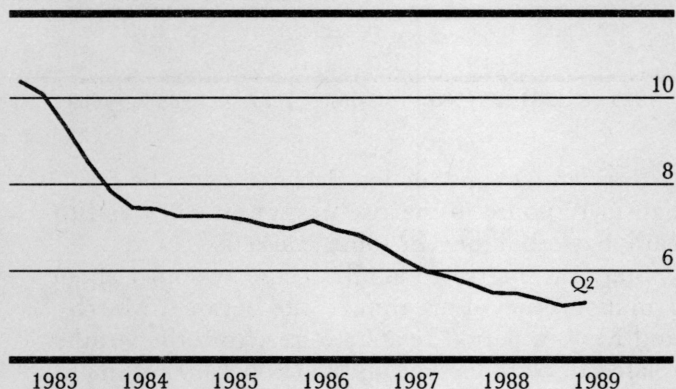
2. Percent of total labor force, including armed forces residing in the United States.

The Performance of the Economy during the First Half of 1989

After two years of rapid expansion, economic activity decelerated substantially in the first half of 1989. Even so, job creation was considerable—nearly 1½ million between December and June—and the civilian unemployment rate, fluctuating around 5¼ percent, remained in the lowest range since the early 1970s.

Civilian Unemployment Rate

Quarterly average, percent



Inflation rose in the first half of 1989, but most of the increase appears to have resulted from transitory events. In particular, energy prices increased sharply, as the rise in crude oil prices between November 1988 and May 1989 was passed through, and food prices surged as the agriculture sector continued to experience adverse supply developments. Outside food and energy, the rate of inflation has, on average, remained at about its 1988 pace, even in the face of relatively high levels of resource utilization.

This apparent stability of underlying price trends is attributable in part to the appreciation of the dollar on exchange markets. So far in 1989, prices of imported goods other than oil have been virtually flat on average, restraining increases in the prices of domestically produced items. In addition, despite the tightest labor markets in some time, wage trends have been fairly stable, helping to limit the acceleration in unit labor costs during a period in which productivity has weakened.

The External Sector

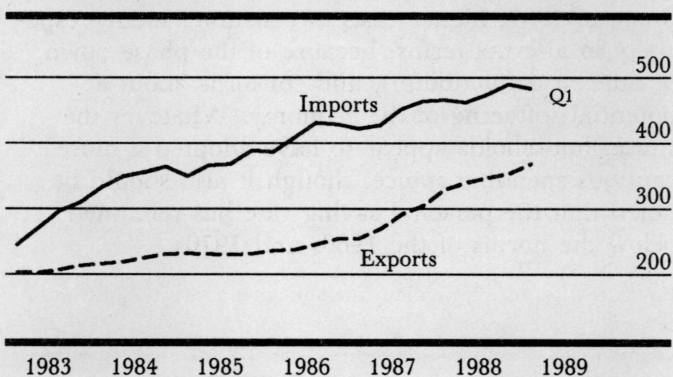
Developments in foreign exchange markets have played an important role in shaping events in the domestic economy in recent years. After depreciating over most of the period from 1985 to late 1987, the foreign exchange value of the dollar in terms of other G-10 currencies changed little, on net, in 1988, as a decline in the final few months reversed much of the increase that had occurred earlier in the year. In December the dollar began to rebound, and it rose substantially through mid-June before dropping back somewhat. The appreciation of the dollar through the first half of 1989 was frequently met by concerted intervention sales of dollars by U.S. and foreign monetary authorities.

Measured in terms of a trade-weighted average of the other G-10 currencies, the dollar is about 8 percent higher than in December 1988 and about 12 percent higher than in December 1987. After adjustment for changes in relative price levels, the appreciation of the dollar has been larger, because U.S. inflation has remained above the average for the other G-10 countries. Meanwhile, the currencies of South Korea and Taiwan have risen moderately against the dollar so far in 1989.

The U.S. merchandise trade deficit in the first quarter was \$110 billion at a seasonally adjusted annual rate, significantly better than the figure for the fourth quarter and that for 1988 as a whole. In the first two months of the second quarter, the trade deficit was essentially unchanged from the first-quarter pace.

U.S. Real Merchandise Trade

Annual rate, billions of 1982 dollars



The Performance of the Economy during the First Half of 1989

Exports have continued to expand this year, although not so rapidly as in 1988. Export gains have been broadly based, with notable increases for agricultural goods, industrial supplies, capital goods, and consumer goods. Meanwhile, imports have increased moderately; in fact, average imports of products other than petroleum in April and May were less than 1 percent above their fourth-quarter rate. Notable decreases were recorded in imports of consumer goods and automotive products. So far in 1989, the value of oil imports has risen sharply, as higher prices for petroleum and petroleum products were accompanied by a small increase in physical volume.

The current account deficit widened in the first quarter to \$123 billion. The increase from the fourth-quarter rate was more than accounted for by capital losses on assets denominated in foreign currencies resulting from the dollar's appreciation. Setting aside those losses, the current account balance in the first quarter showed a deficit of \$108 billion, an improvement of about \$22 billion from the previous quarter.

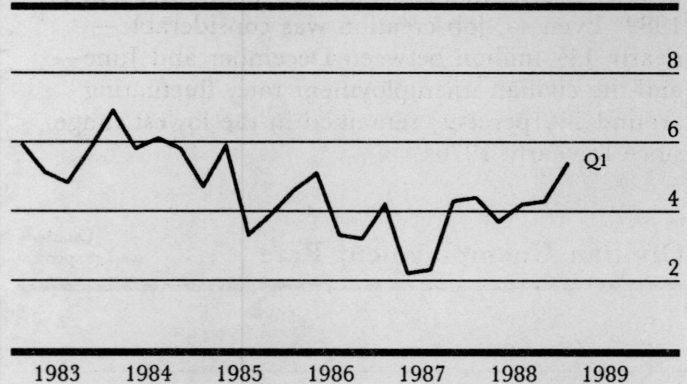
The Household Sector

Much of the slowing in overall economic growth in the first half of 1989 reflected a deceleration in consumer spending. The slump in demand was fairly broad, encompassing a variety of durable and non-durable goods.

The personal saving rate has been on a distinct upswing since reaching a forty-year low in mid-1987. Several explanations have been propounded for the recent rise, among them the lower level of household net worth relative to income since the stock market break of 1987, higher costs of consumer credit (especially in aftertax terms, because of the phase-down of interest deductibility), and concerns about a potential softening of the economy. Whatever the cause, households appear to have adopted a more cautious spending stance, though it also should be noted that the personal saving rate has remained below the norms of the 1960s and 1970s.

Personal Saving

Percent of disposable income



Residential construction declined over the first half in response to the rise in interest rates and to earlier overbuilding in some markets.

Starts in the single-family sector averaged about 1 million units at an annual rate between March and May, a period relatively free from the weather-related distortions that affected construction in January and February.

Meanwhile, multifamily starts fell further in the first half of the year from the already low level recorded in 1988.

The Business Sector

In contrast to the household sector, business capital spending strengthened in early 1989. In the first quarter of 1989, real business fixed investment rose at an annual rate of 7½ percent, and such spending appears to have increased substantially further in the second quarter.

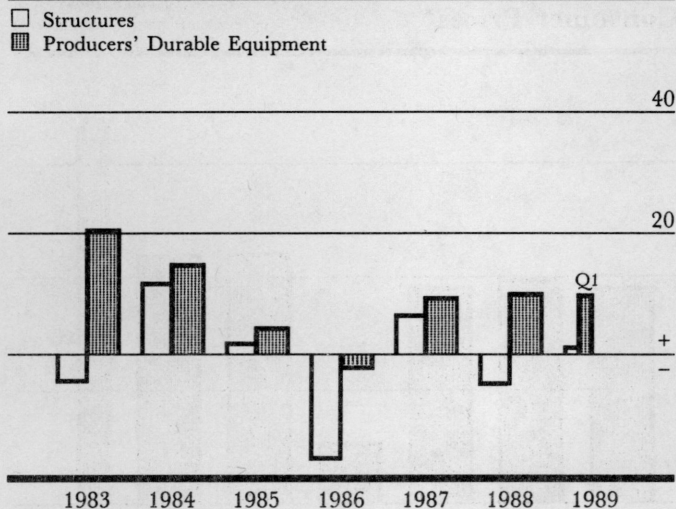
Particularly noteworthy in the first quarter was a sharp rise in outlays for industrial machinery. Increases in that area, which includes spending for fabricated metal products, engines, turbines, and a variety of other types of industrial apparatus, have been exceptionally strong since mid-1987. Spending for high-technology equipment also has been robust.

Inventory investment slowed over the first five months of 1989, as businesses adjusted with apparent promptness to the more moderate expansion of final demand.

In the first quarter of 1989, before-tax economic profits of nonfinancial corporations declined, in part because unit labor costs increased as sales growth slowed and productivity deteriorated. The drop in profits was spread over most types of businesses; the largest decline was in the manufacturing sector, which had especially strong gains in both 1987 and 1988.

Real Business Fixed Investment

Percent change from end of previous period, annual rate



The Government Sector

In the first quarter, real federal purchases of goods and services, the part of federal outlays that is counted directly in GNP, were virtually unchanged. Such purchases are dominated by defense; nominal spending authority in this area has been virtually flat since 1985, and procurement of some major new weapon systems is winding down.

On a unified budget basis, total nominal outlays for the fiscal year through May were more than 6 percent above the comparable year-earlier total. Spending related to the thrift institution problem spiked at year-end 1988 and then dropped sharply in

the first half of this year. On the other hand, growth has continued in entitlement spending (principally Medicare and Social Security) and in net interest outlays.

Federal receipts have grown even more rapidly than outlays, buoyed by increases in employment and income.

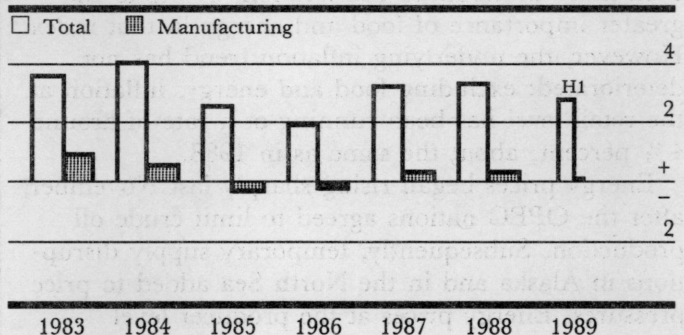
Real purchases of goods and services by state and local governments have been on a moderate uptrend this year. Outlays for personnel and construction in the education and law enforcement areas have been subject to considerable upward pressure. Some other expenditures have risen because of federal mandates, especially those in recent health legislation. As in the federal sector, growth of state and local outlays has been tempered by budgetary pressures; excluding retirement trust funds, which are running a large surplus, the sector had a deficit of about \$17 billion at an annual rate in the first quarter.

Labor Markets

Job growth was substantial over the first half of 1989, though it slowed in the spring. In the first quarter, additions to nonfarm payrolls averaged 264,000 a month, about the same pace seen over the prior two years. By spring, hiring had begun to slow, and payroll employment growth dropped back to 200,000 per month in the second quarter as a whole.

Nonfarm Payroll Employment

Net change, millions of persons, annual rate



The moderation in the growth of the demand for labor in the second quarter did not lead to any appreciable reduction in labor market tightness. The unemployment rate has fluctuated between 5.0 and 5.4 percent thus far this year; in June it stood at 5.3 percent.

Average hourly earnings of production and non-supervisory workers accelerated from late 1986 through mid-1988; since then the rate of increase has flattened out, and in June earnings were up 3¾ percent from a year earlier. The employment cost index for wages and salaries in the private nonfarm sector, a broader measure of wages that is available only through March, indicated some easing of wage trends in the goods-producing sector; however, in the service-producing industries, the trend remained sharply upward. Total compensation per hour—wages and salaries plus benefits—was up 4½ percent over that period, in the same range as the 12-month increases recorded in the preceding three quarters.

Productivity performance has deteriorated somewhat in recent quarters.

Price Developments

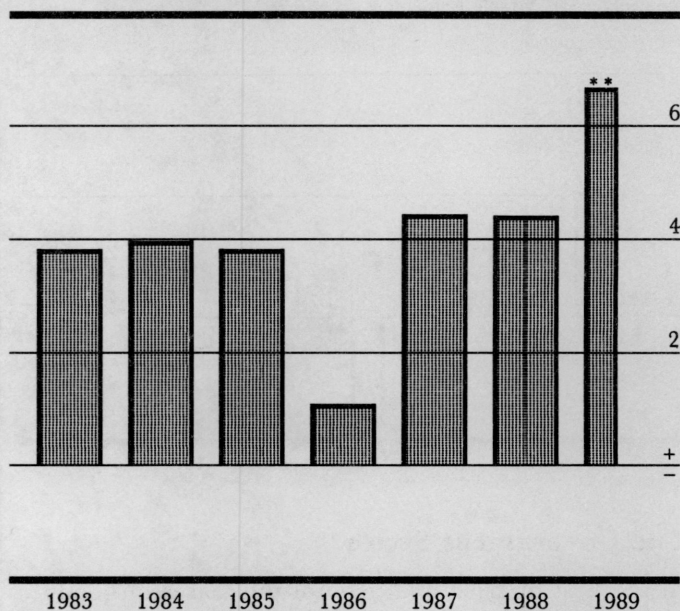
Inflation increased sharply in early 1989, reflecting higher costs for food and energy. The consumer price index for all items, a broad-based measure for finished goods and services, rose at an annual rate more than 6 percent through May, compared with the 4½ percent pace in 1987 and 1988. The producer price index for finished goods recorded an even more pronounced acceleration, owing to the greater importance of food and energy in that index. However, the underlying inflation trend has not deteriorated: excluding food and energy, inflation at the retail level has been running at a rate of around 4¾ percent, about the same as in 1988.

Energy prices began rising sharply last November, after the OPEC nations agreed to limit crude oil production. Subsequently, temporary supply disruptions in Alaska and in the North Sea added to price pressures. Energy prices at the producer level soared, and consumer energy prices rose nearly 25 percent at an annual rate between December and May. More recently, posted prices of crude oil have remained between \$19 and \$20 per barrel.

Increases in retail food prices were large in the first half of 1989, in part reflecting the lingering effects of last summer's drought and additional damage to some crops this year. From the beginning of the year through May, the rise in the CPI for food was close to 8 percent at an annual rate. Although drought curtailed the winter wheat crop for 1989, total crop acreage has expanded, and overall production should rebound this year, if weather conditions are satisfactory.

Consumer Prices*

Percent change from end of previous period, annual rate



*Consumer Price Index for all urban consumers.

**Percent change from December 1988 to May 1989.

Excluding food and energy, prices for commodities at the consumer level have risen at a rate slightly lower than that recorded for 1988. A marked diminution of increases in non-oil import prices associated with the appreciation of the dollar apparently has restrained the prices of many goods, notably apparel and a variety of household items. In contrast, inflation in the service sector has increased, especially in labor-intensive services, such as medical care, entertainment, and public transportation.

Monetary Policy and Financial Developments during the First Half of 1989

In conducting monetary policy over the first half of the year, the Federal Open Market Committee continued its effort to foster long-run price stability, so as to build a base for sustainable expansion of the economy. In again reducing the ranges for money and debt growth at its February meeting, the Committee recognized that restraint on the expansion of money and credit would be needed to promote this goal.

Relatively wide monetary ranges—4 percentage points in breadth—were retained, in part to take account of the substantial interest-rate sensitivity of money demand over horizons of as long as a year and of the unpredictable effects on money demand of the resolution of the crisis in the thrift industry. Moreover, in these circumstances, the Committee recognized that, in addition to the behavior of the monetary aggregates, a variety of indicators of inflationary pressures and the course of economic activity would have to be taken into account in shaping policy over 1989.

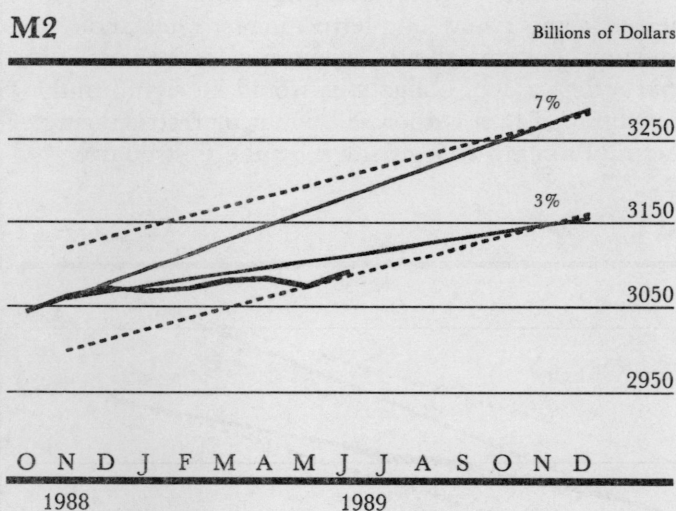
The Implementation of Monetary Policy

As noted previously, developments early in 1989 suggested that a worrisome risk remained that inflation was picking up and could become more deeply embedded in the economy. Wage and benefit costs had accelerated in 1988, and the readings for the consumer and producer price indexes were troubling. Extending the move toward restraint that began almost a year earlier, the Federal Reserve increased reserve market pressures at the start of this year and again in mid-February. On February 24 the discount rate was raised 1/2 percentage point to 7 percent.

These policy actions were accompanied by marked increases, of about a percentage point, in most short-term interest rates. Yields on long-term securities also moved up, but by considerably less than short-term rates. The foreign exchange value of the dollar strengthened as interest rates in the United States rose relative to those abroad. Money growth slowed: M1 was roughly flat in the first quarter, and M2 and M3 decelerated from already reduced rates in the second half of 1988.

Many interest rates began to move off their March highs early in the second quarter as indications mounted of moderation in the pace of economic activity and in underlying price pressures. Market expectations of some additional tightening of monetary policy shifted to anticipations of an easing.

The FOMC eased policy slightly at the beginning of June and again in early July. The federal funds rate moved down about 1/2 percentage point in two steps to around 9 1/4 percent. Evidence that the more moderate pace of economic activity was persisting, indicators of the behavior of wages and sensitive prices, and the weakness of the monetary aggregates all were consistent with a prospective ebbing of inflationary pressures. Moreover, the dollar was appreciably above year-end levels, which could be expected to have favorable effects in restraining inflation. While inflation remained a concern, an intensification of price pressures did not appear to be a present danger, and the risks of cumulating weakness in the economy had increased.



The Behavior of the Monetary Aggregates

Growth of the monetary aggregates was quite sluggish over the first half of 1989, reflecting the effects of increases through March in market interest rates relative to returns on monetary assets, some depositor concern over the problems of the thrift industry, and large tax payments by individuals. From the fourth quarter of 1988 through June, M2 edged up at an annual rate of only 2 percent, markedly below last year's pace of 5¼ percent. M2 velocity rose sharply through the second quarter. Even so, as depositors rebuilt their holdings of monetary assets, M2 grew at an annual rate of 6¾ percent in June.

M3 grew at an annual rate of 3½ percent from the fourth quarter of last year to June, placing it at the lower bound of its target range. In the first quarter, expansion of M3 was subject to offsetting forces. It was bolstered somewhat by bank funding needs generated by strong demand for business loans. Added demand for commercial and industrial loans stemmed both from merger-related financings and from shifts to short-term borrowing by businesses facing rising long-term interest rates and investor concerns about "event risk"—the possibility that a firm's debt obligations would be significantly downgraded in a corporate buyout or restructuring. Acting to damp M3 growth over the first quarter,

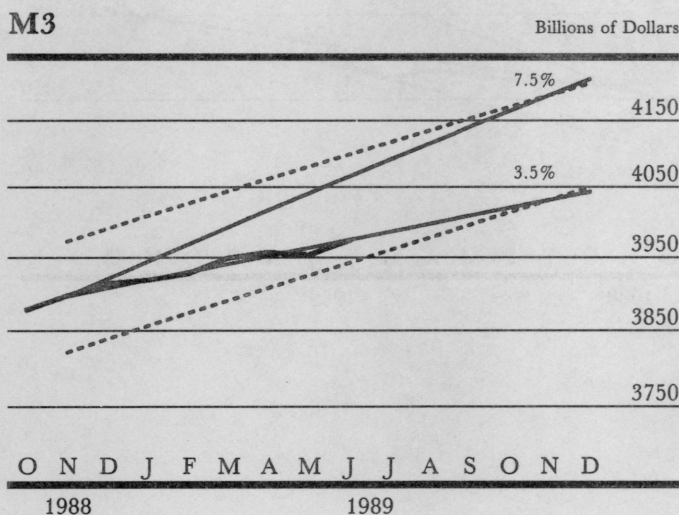
however, was heavy reliance by thrift institutions on Federal Home Loan Bank advances and other borrowings, which are not included in the money stock. M3 growth edged down a bit in the second quarter with some easing of bank credit demands and strong growth in government deposits—also not included in the money stock—resulting from the large volume of tax payments. By June, however, M3 had rebounded as tax effects unwound.

Credit Flows

The aggregate debt of domestic nonfinancial sectors expanded at an annual rate of close to 8 percent over the first half of this year, near the midpoint of its monitoring range and down somewhat from its 1988 pace. The growth of federal sector debt slowed as tax receipts surged. Expansion of the debt of non-federal sectors also moderated, partly in response to higher levels of market interest rates over much of the first half of the year. Household borrowing in mortgage markets slowed as increases in lending rates damped housing demand, while the pace of consumer borrowing slackened along with the deceleration in consumption spending.

Mortgage lending by thrift institutions did not appear to be unusually weak in the first few months of 1989, given the prevailing interest rates. These institutions coped with weak deposit flows by running off cash and investments and, through the first quarter, stepping up borrowing from the Federal Home Loan Banks. Despite signs of a reduction in mortgage lending activity by these institutions in the second quarter, the overall availability of housing credit did not appear to be significantly impaired.

Total borrowing by nonfinancial businesses in the first half of the year was close to its 1988 pace. Credit demands continued to be buoyed by sizable merger-related financing in the first quarter, and an apparent pickup in capital expenditures increased business borrowing in the second quarter even as credit demands related to mergers and restructurings, while still strong, eased a bit.



Growth of Money and Debt (Percent)

		M1	M2	M3	Debt of Domestic Nonfinancial Sectors
Fourth quarter to fourth quarter	1979	7.7	8.2	10.4	12.3
	1980	7.4	9.0	9.6	9.6
	1981	5.2 (2.5)*	9.3	12.3	10.0
	1982	8.7	9.1	9.9	9.0
	1983	10.2	12.1	9.8	11.3
	1984	5.3	7.7	10.5	14.2
	1985	12.0	8.9	7.7	13.2
	1986	15.6	9.3	9.1	13.4
	1987	6.4	4.2	5.7	9.8
	1988	4.3	5.2	6.2	8.9
Quarterly growth rates 1989 (annual rates)	Q1	- .4	1.9	3.7	8.2
	Q2	-5.5	1.3	3.1	7.4 ^e

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

e—estimated

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Footnotes

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

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

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

A copy of the full report to Congress is available from
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