1990 Monetary Policy Objectives

Summary Report of the Federal Reserve Board

February 20, 1990

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

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

Economic and Monetary Policy Developments in 1989

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

About a year ago, Federal Reserve policy was in the final phase of a period of gradual tightening, designed to inhibit a buildup of inflation pressures. Interest rates moved higher through the winter, but started down when signs of more restrained aggregate demand and of reduced potential for higher inflation began to appear. As midyear approached, a marked strengthening of the dollar on foreign exchange markets further diminished the threat of accelerating inflation. New economic data suggested that the balance of risks had shifted toward the possibility of an undue weakening in economic activity. With M2 and M3 below the lower bounds of their annual ranges in the spring, the Federal Reserve in June embarked on a series of measured easing steps that continued through late last year. Across the maturity spectrum, interest rates declined further, to levels about 1½ percentage points below March peaks. Reductions in inflation expectations and reports of a softer economy evidently contributed to the drop in rates in longer-term markets.

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

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

The Ultimate Objectives and Medium-Term Strategy of Monetary Policy

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

The strategy of the Federal Open Market Committee (FOMC) for moving toward this goal remains the same—to restrain growth in money and aggregate demand in coming years enough to establish a clear downward tilt to the trend of inflation and inflation expectations, while avoiding a recession. Approaching price stability may involve a period of expansion in activity at a rate below the growth in the economy's potential, thereby relieving pressures on resources. Once some slack develops, real output growth can pick up to around its potential growth rate, even as inflation continues to trend down. Later, as price stability is approached, real output growth can move still higher, until full resource utilization is restored.

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

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

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

This qualitative description of our medium-term strategy is easy to state, but actually implementing it will be difficult. Unexpected developments no doubt will require flexible policy responses. Any such adjustments will not imply a retreat from the medium-term strategy or from ultimate policy goals. Rather, they will be mid-course corrections that attempt to keep the economy and prices on track. The easing of reserve pressures starting last June is a case in point. Successive FOMC decisions to ease operating policy were intended to forestall an economic downturn, the chances of which seemed to be increasing as the balance of risks shifted away from greater inflation. The FOMC was in no way abandoning its long-run goal of price stability. Instead, it sought financial conditions that would support the moderate economic expansion judged to be consistent with progress toward stable prices. In the event, output growth was sustained last year, although in the fourth quarter a major strike at Boeing combined with the first round of production cuts in the auto industry accentuated the underlying slowdown. On the inflation side, price increases in the second half were appreciably lower than those in the first. Although the CPI for January, as expected, showed a sizable jump in energy and food prices in the wake of December's cold snap, a reversal is apparently underway.

Monetary Policy and the Economic Outlook for 1990

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

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

In contrast with M2, the range for M3 has been reduced from its tentative range set last July. The new M3 range of 2½ to 6½ percent is intended to embody the same degree of restraint as the M2 range, but it was lowered to reflect the continued decline in thrift assets and funding needs now anticipated to accompany the ongoing restructuring of the thrift industry. This asset runoff began in earnest in the second half of last year, so its magnitude was not incorporated into the tentative M3 range for 1990 set last July. The bulk of the mortgage and real estate assets that thrifts will shed are expected to be acquired by the Resolution Trust Corporation and diversified investors other than depository institutions. Such assets thus will no longer be financed by monetary instruments included in M3. In addition, commercial banks are likely to be more cautious in their lending activities, reducing their need to issue wholesale managed liabilities included in M3. These influences should retard the growth of M3 relative to M2 again this year.

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

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

The Committee's best judgment is that money and debt growth within these annual ranges will be compatible with a moderation in the expansion of nominal GNP. Most FOMC members and other Reserve Bank presidents foresee real GNP growing 1¾ to 2 percent over the year as a whole. Such a rate would be around last year's moderate pace, excluding the rebound in agricultural output from the 1988 drought. A slight easing of pressures on resources probably is in store. Inflation pressures should remain contained, even though the decline in the dollar's value over the past half-year likely will reverse some of the beneficial effects on domestic inflation stemming from the dollar's earlier appreciation. The CPI this year is projected to increase 4 to 4½ percent, as compared with last year's 4½ percent.

Risks to the Economic Outlook

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

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

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

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

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

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

International Financial Markets and Monetary Policy

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

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

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

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

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

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

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

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

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

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

Developments within U.S. financial markets remain the strongest influence on the asset prices and interest rates determined by those markets and, through them, on the U.S. economy. Exchange rates absorb much of the impact of developments in foreign asset markets, permitting U.S. interest rates to reflect primarily domestic economic conditions. Exchange rates influence the prices of products that do, or can, enter into international trade. Such factors can bring about changes in the composition of production between purely domestic goods and services and those entering international trade, and they can affect aggregate price movements for a time.

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

Monetary policy is only one tool, however, and it cannot be used successfully to meet multiple objectives. The Federal Reserve, for example, can address itself to either domestic prices or exchange rates but cannot be expected to achieve objectives for both simultaneously. Monetary policy alone is not readily capable of addressing today's large current account deficit, which is symptomatic of underlying imbalances among saving, spending, and production within the U.S. economy. Continued progress in reducing the federal deficit is a more appropriate instrument to raise domestic saving and free additional resources for productive investment. The long-term health of our economy requires the balanced use of monetary and fiscal policy in order to reach all of the nation's policy objectives.

1990 MONETARY POLICY OBJECTIVES

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

February 20, 1990

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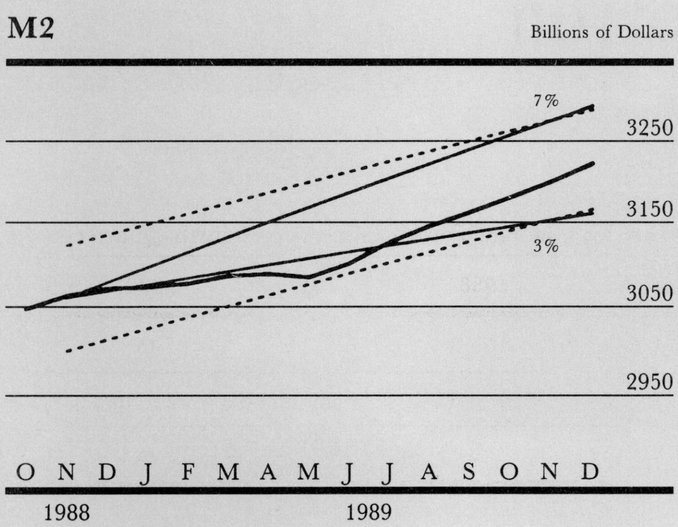
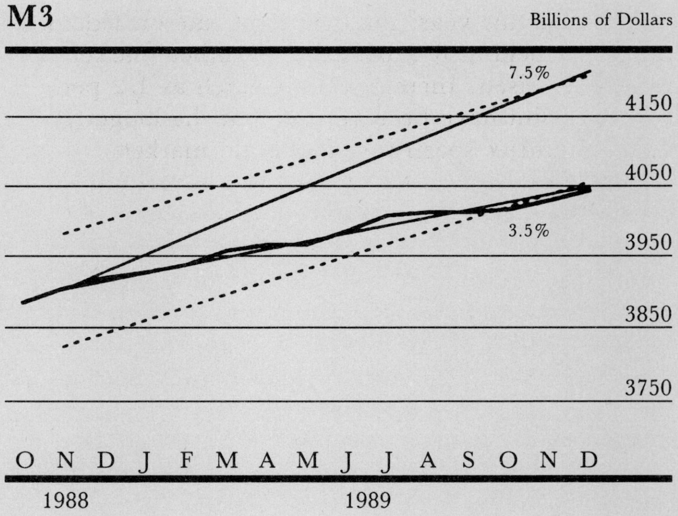
Monetary Policy and the Economic Outlook for 1990

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

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





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

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

Thus far this year, the overnight rate on federal funds has held at 8¼ percent, but other market rates have risen. Increases of as much as 1/2 percentage point have been recorded at the longer end of the maturity spectrum. The bond markets responded to indicators suggesting a somewhat greater-than-anticipated buoyancy in economic activity—which may have both raised expected real returns on investment and renewed some apprehensions about the outlook for inflation. The rise in yields occurred in the context of a general runup in international capital market yields, which appears to have been in part a response to emerging opportunities associated with the opening of Eastern Europe; this development had particularly notable effects on the exchange value of the West German mark, which rose considerably relative to the dollar, the yen, and other non-EMS currencies.

Monetary Policy for 1990

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

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

The Committee reduced the M3 range to 2½ to 6½ percent to take account of the effects of the restructuring of the thrift industry, which is expected to continue in 1990. A smaller proportion of mortgages is likely to be held at depository institutions and financed by elements in M3; thrift institution assets should continue to decline, as some solvent thrifts will be under pressure to meet capital standards and insolvent thrifts will continue to be shrunk and closed, with a portion of their assets carried, temporarily, by the government. An increase in lender—and borrower—caution more generally points to some slowing in the pace at which nonfinancial sectors take on debt relative to their income in 1990. In particular, recent developments suggest that leveraged buyouts and other transactions that substitute debt for equity in corporate capital structures will be noticeably less important in 1990 than in recent years. Moreover, a further decline in the federal sector's deficit is expected to reduce credit growth this year. In light of these considerations, the Committee reduced the monitoring range for debt of the nonfinancial sectors to 5 to 9 percent.

The setting of targets for money growth in 1990 is made more difficult by uncertainty about developments affecting thrift institutions. The behavior of M3 and, to a more limited extent, M2 is likely to be affected by such developments, but there is only limited basis in experience to gauge the impact.

Ranges of Growth for Monetary and Credit Aggregates[1]

(Percent Change, Fourth Quarter to Fourth Quarter)

	1988	1989	1990
M2	4 to 8	3 to 7	3 to 7
M3	4 to 8	3½ to 7½	2½ to 6½
Debt	7 to 11	6½ to 10½	5 to 9

Economic Projections for 1990

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

Given their importance in determining the trend of overall costs, a deceleration in the cost of labor inputs is an integral part of any solid progress toward price stability. Unfortunately, the near-term prospects for a moderation in labor cost pressures are not favorable. Compensation growth is being boosted in the first half of 1990 by an increase in social security taxes and a hike in the minimum wage. The anticipated easing of pressures in the labor market should help produce some moderation in the pace of wage increases in the second half of 1990, but the Committee will continue to monitor closely the growth of labor costs for signs of progress in this area.

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

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

Relative to the Committee, the Administration currently is forecasting more rapid growth in real and nominal GNP. At the same time, the Administration's projection for consumer price inflation is at the low end of the Committee's central tendency range.

Most Committee members believe that growth in nominal GNP will be between 5½ and 6½ percent, but a more rapid expansion in nominal income would be welcome if it promised to be accompanied by a declining path for inflation in 1990 and beyond.

Economic Projections for 1990

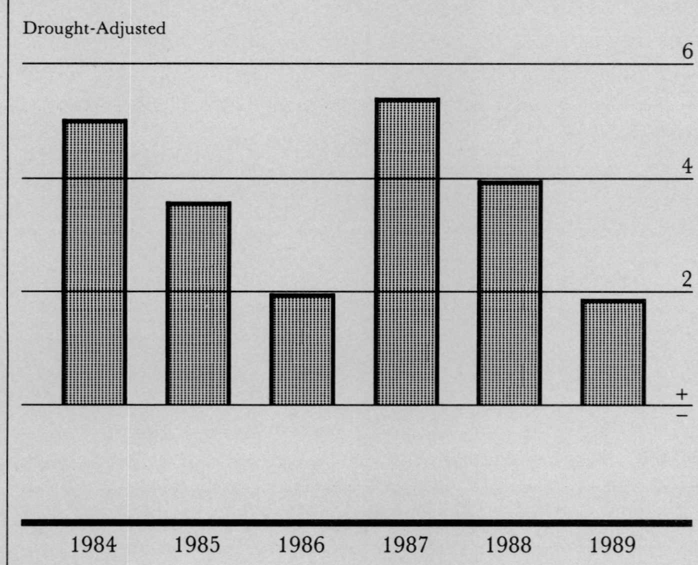
		1989 Actual	FOMC Members and other FRB Presidents		Administration
			Range	Central Tendency	
Percent change, fourth quarter to fourth quarter:	Nominal GNP	6.4	4 to 7	5½ to 6½	7.0
	Real GNP	2.4	1 to 2¼	1¾ to 2	2.6
	Consumer price index	4.5	3½ to 5	4 to 4½	4.1[1]
Average level in the fourth quarter, percent: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

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

The Performance of the Economy in 1989

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

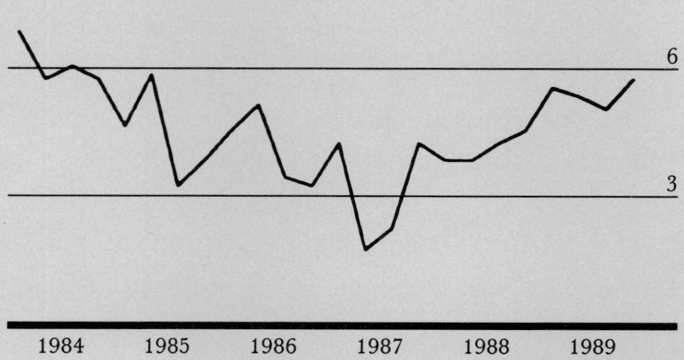
Real GNP Percent change, Q4 to Q4



The Household Sector

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

Personal Saving Percent of disposable income



The slackening in consumer demand was concentrated in spending on goods. Real spending on durable goods was about unchanged from the fourth quarter of 1988 to the fourth quarter of 1989—after jumping 8 percent in the prior year—chiefly reflecting a slump in purchases of motor vehicles.

Residential investment fell in real terms through the first three quarters of 1989, and with only a slight upturn in the fourth quarter, expenditures decreased 6 percent on net over the year. Construction was weighed down throughout 1989 by the overbuilding that occurred in some locales earlier in the decade. Vacancy rates were especially high for multifamily rental and condominium units. In the single-family sector, affordability problems constained demand, dramatically so in those areas in which home prices had soared relative to household income.

The Business Sector

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

Nonfarm business inventory investment averaged $21 billion in 1989. Although the average pace of accumulation last year was slower than in 1988, the pattern across sectors was somewhat uneven. Nonetheless, most sectors of the economy have adjusted fairly promptly to the deceleration in sales, and appear to have succeeded in preventing serious overhangs from developing.

The Government Sector

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

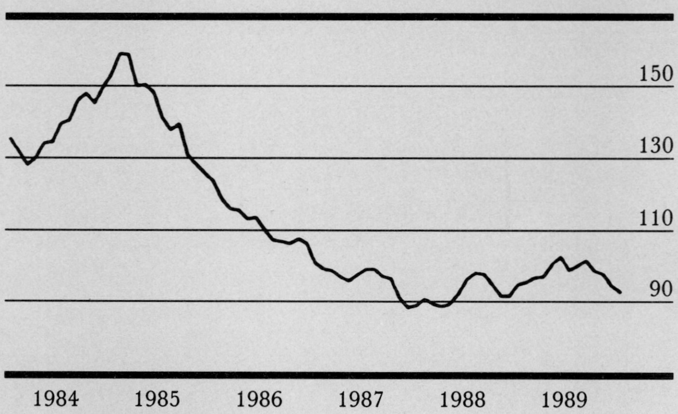
Purchases of goods and services at the state and local level increased 2½ percent in real terms over the four quarters of 1989, down more than a percentage point from the average pace of the preceding five years. Nonetheless, there were some areas of growth. Spending for educational buildings increased, and employment in the state and local sector rose 350,000 over the year, largely driven by a pickup in hiring by schools. Despite the overall slowdown in the growth of purchases, the budgetary position of the state and local sector deteriorated further over the year.

The External Sector

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

Foreign Exchange Value of the U.S. Dollar*

Index, March 1973 = 100

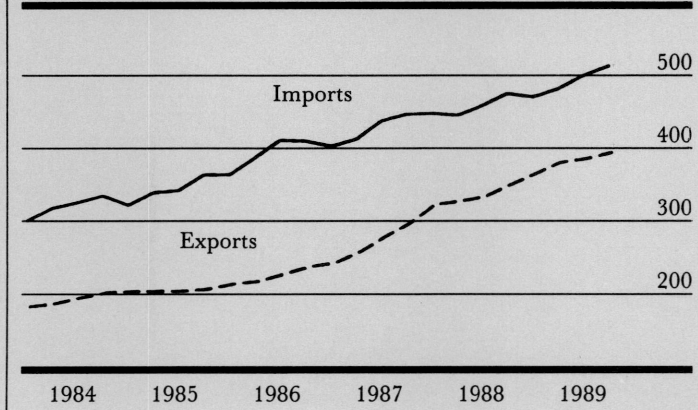


*Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of other G-10 countries plus Switzerland. Weights are 1972-76 global trade of each of the 10 countries.

On a GNP basis, merchandise exports increased about 11 percent in real terms over the four quarters of 1989—roughly 4 percentage points less than in 1988.

U.S. Real Merchandise Trade

Annual rate, billions of 1982 dollars

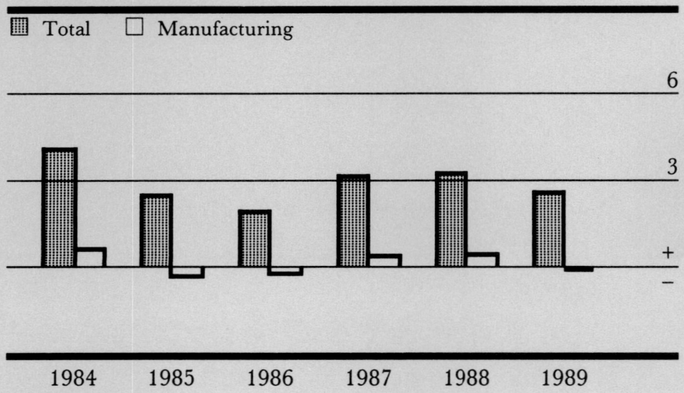


Merchandise imports excluding oil expanded about 7 percent in real terms during 1989, with much of the rise accounted for by imports of computers. Imports of oil increased 6 percent from the fourth quarter of 1988 to the fourth quarter of 1989, to a rate of 8.3 million barrels per day. At the same time,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

The counterpart of the current account deficit of $106 billion at an annual rate over the first three quarters of 1989 was a recorded net capital inflow of about $60 billion at an annual rate and an unusually large statistical discrepancy, especially in the second quarter.

Nonfarm Payroll Employment

Net change, millions of persons, Q4 to Q4



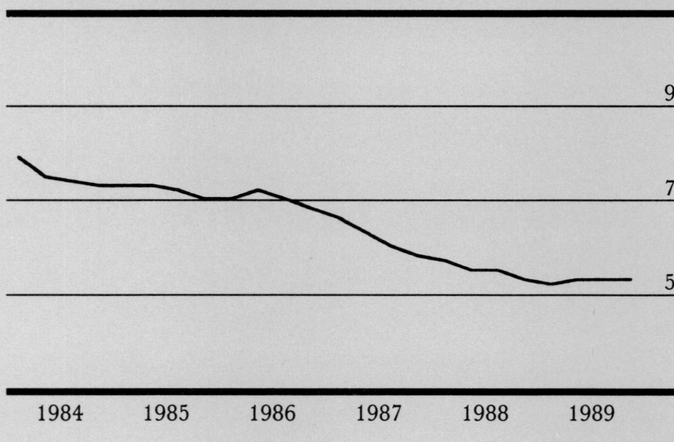
Labor Markets

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

Despite the slowdown in new job creation, the overall balance of supply and demand in the labor market remained steady over the year. The civilian unemployment rate, which had declined about 1/2 percentage point over the twelve months of 1988, finished 1989 at 5.3 percent—unchanged from twelve months earlier.

Civilian Unemployment Rate

Quarterly average, percent



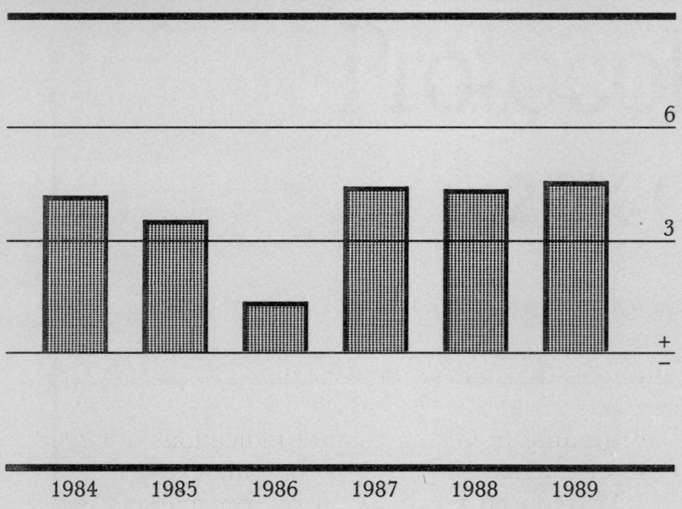
A slowdown in the growth of productivity often accompanies a softening in the general economy, and productivity gains were lackluster in 1989. Output per hour in the private nonfarm business sector increased only 1/2 percent over the four quarters of the year—1 percentage point below the rate of increase in 1988. In the manufacturing sector, productivity gains during the first half of 1989 kept pace with the 1988 average of 3 percent; in the second half, however, productivity growth slowed to an annual rate of 2¼ percent.

Price Developments

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

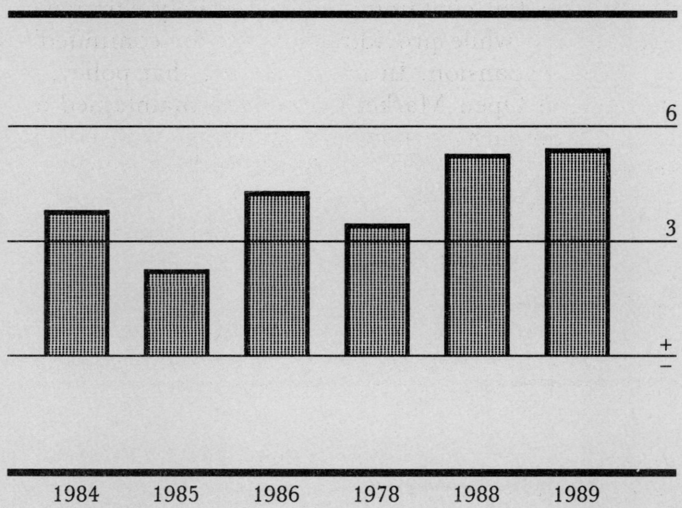
Food prices increased 5½ percent at the retail level, slightly more than in 1988 when a number of crops were severely damaged by drought. Continued supply problems in some agricultural markets in 1989—notably a poor wheat crop and a shortfall in dairy production—likely prevented a deceleration from the drought-induced rate of increase in 1988.

Consumer Prices* Percent change, Q4 to Q4



*Consumer Price Index for all urban consumers.

Consumer Food Prices* Percent change, Q4 to Q4



*Consumer Price Index for all urban consumers.

Consumer energy prices surged 17 percent at an annual rate during the first six months of 1989, before dropping back 6 percent in the second half. Consumer price increases for items other than food and energy remained at about 4½ percent in 1989. In contrast to goods prices, the prices of nonenergy services—which make up half of the overall consumer price index—increased 5¼ percent in 1989, 1/4 percentage point more than in 1988. The pickup in this category was led by rents, medical services, and entertainment services.

Monetary and Financial Developments during 1989

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

As the year began, monetary policy was following through on a set of measured steps begun a year earlier to check inflationary pressures. By then, however, evidence of a slackening in aggregate demand, along with sluggish growth of the monetary aggregates, suggested that the year-long rise in short-term interest rates was noticeably restraining the potential for more inflation. But, after a 1/2 percentage point increase in the discount rate at the end of February, the Federal Reserve took no further policy action until June. Over the balance of 1989, the Federal Reserve moved toward an easing of money market conditions, as indications mounted of a slack in demand and lessened inflation pressures. The easing in reserve availability induced declines in short-term interest rates of 1½ percentage points; money growth strengthened appreciably, and M2 was near the middle of its target range by the end of 1989. The level of M3, on the other hand, remained around the lower bound of its range, with its weakness mostly reflecting the shifting pattern of financial intermediation as the thrift industry retrenched. The growth of nonfinancial debt was trimmed to 8 percent in 1989, about in line with the slowing in the growth of nominal GNP, and ended the year at the midpoint of its monitoring range.

Implementation of Monetary Policy

In the opening months of the year, the Federal Open Market Committee extended the move toward restraint that had begun almost a year earlier, seeking to counter a disquieting intensification of inflationary pressures. Policy actions in January and February, restraining reserve availability and raising the discount rate, prompted a further 3/4 percentage point increase in short-term market interest rates.

As evidence on prospective trends in inflation and spending became more mixed in the second quarter, the Committee refrained from further tightening and in June began to ease pressures on reserve markets. As the information on the real economy, along with the continued rise in the dollar, suggested that the outlook for inflation was improving, most long-term nominal interest rates fell as much as a percentage point from their March peaks; the yield on the bellwether thirty-year Treasury bond moved down to about 8 percent by the end of June.

In July, when the FOMC met for its semiannual review of the growth ranges for money and credit, M2 and M3 lay at or a bit below the lower bounds of their target cones. This weakness, reinforcing the signals from prices and activity, contributed to the Committee's decision to take additional easing action in reserve markets.

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

Beginning in October, amid indications of added risks of a weakening in the economic expansion, the FOMC reduced pressures on reserve markets in three separate steps, which nudged the federal funds rate down to around 8¼ percent by year-end, about 1½ percentage points below its level when incremental tightening ceased in February.

Behavior of Money and Credit

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

The M1 component of M2 was especially affected by the swings in interest rates and opportunity costs last year, and in addition was buffeted by the effects of outsized tax payments in April. After its 4¼ percent rise in 1988, M1 grew only 1/2 percent in 1989, with much of the weakness in this transactions aggregate occurring early in the year.

The shift of deposits from thrift institutions to commercial banks and money fund shares owed, in part, to regulatory pressures that brought down rates paid by some excessively aggressive thrifts. On balance, the weak growth of retail deposits at thrifts appears to have been about offset by the shift into

Growth of Money and Debt (Percent change)

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

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

commercial banks and money market mutual funds, leaving M2 little affected overall by the realignment of the thrift industry.

M3 was largely driven, as usual, by the funding needs of banks and thrifts; under the special circumstances of the restructuring of the thrift industry, it was a less reliable barometer of monetary policy pressures than is normally the case. After expanding 6¼ percent in 1988, M3 hugged the lower bound of its 3½ to 7½ percent target cone in 1989, closing the year about 3¼ percent above its fourth quarter-1988 base. In 1989, bank credit growth about matched the previous year's 7½ percent increase, but credit at thrift institutions is estimated to have contracted a bit on balance over the year, in contrast to its 6¼ percent growth in 1988.

Aggregate debt of the domestic nonfinancial sectors grew at a fairly steady pace over 1989, averaging 8 percent, which placed it near the midpoint of its monitoring range of 6½ to 10½ percent. Although the annual growth of debt slowed in 1989, as it had during the preceding two years, it still exceeded the 6½ percent growth of nominal GNP. Federal sector debt grew 7½ percent, about 1/2 percentage point below the 1988 increase—and the lowest rate of expansion in a decade—as the deficit leveled off.

Footnotes

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

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

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

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

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