1991 MONETARY POLICY OBJECTIVES

Midyear Review of the Federal Reserve Board

July 16, 1991

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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 am pleased to be here today to present the midyear Monetary Policy Report to the Congress. My prepared remarks this morning will take their cue from that Report by focusing on current economic and financial conditions, as well as on the outlook for the economy and monetary policy over the coming year and a half. These topics merit particularly close attention at the current time, when the economy appears to be poised at a cyclical turning point—moving from recession to expansion. In addition, I plan to devote some time to discussing the importance of the changes that we have been seeing in patterns of credit usage and in the flows of money and credit through the financial system. There are signs of what could be significant departures from the trends prevalent in the 1980s, with potential implications for the interpretation of financial data and economic developments.

Economic and Financial Developments in the First Half of 1991

At the time of our last Report in February, the economy had been declining for several months. The considerable uncertainty and higher oil prices that followed the invasion of Kuwait had depressed confidence and real incomes, discouraging spending by consumers and businesses and pulling down output and employment. However, even by February, the first seeds of an economic recovery appeared to have been sown: The initial coalition successes in the Gulf War, the reversal of much of the runup in oil prices, and the significant easing of monetary policy all pointed in the direction of a resumption of growth.

Today, there are compelling signs that the recession is behind us. Although the turning point has not yet been given a precise date, a variety of cyclical indicators bottomed out by early spring, and some have moved noticeably higher in recent months. Such data strongly suggest that the economy is moving into the expansion phase of the cycle. Nevertheless, convincing evidence of a dynamic expansion is still rather limited, and we must remain alert to the chance that the recovery could be muted or could even falter.

In recent months, there also have been promising signs of a slowing in inflation. The price figures themselves have bounced around from month to month, partly in response to the gyrations in oil prices and the partial embedding of those swings in the underlying cost structure of the economy. A bunching of price increases and excise tax hikes at the beginning of the year also boosted ''core'' inflation measures for a time. But in their wake, an underlying softening trend has become evident, with consumer prices outside of the food and energy sectors rising quite modestly. In an environment of slack demand, businesses have worked especially hard to control costs by keeping their operations as lean and productive as possible.

With the threat of an oil-related inflation surge largely behind us and output evidently declining, the Federal Reserve took a series of easing steps in quick succession over the latter part of last year and into the spring. These actions, aimed at ensuring a satisfactory upturn in the economy, brought the federal funds rate more than 2 percentage points below its pre-recession level and 4 percentage points below its peak of about two years ago. Other short-term interest rates dropped more or less commensurately. Despite the progressive easing of monetary policy, the foreign exchange value of the dollar is up substantially since the beginning of the year, in part owing to the brightening outlook in the United States for economic recovery without added inflation. Anticipations of economic expansion also were reflected in rising stock prices and in long-term interest rates, which have changed relatively little on balance so far this year even as short-term rates have declined.

With the cumulative drop in short-term interest rates making monetary assets more attractive to the public, M2 growth picked up noticeably in the first half of 1991. Its growth probably was restrained to a degree, however, by the firmness in returns on capital market instruments. And, as had been anticipated at the beginning of the year, growth of M2 remained below what would have been predicted solely on the basis of historical relationships with interest rates and income. Money growth also continued to be held down by the ongoing restructuring of credit flows away from depository institutions. As the thrift industry has contracted and banks have remained quite cautious about expanding their balance sheets, there has been less need for depositories to issue liabilities—which constitute the vast bulk of the monetary aggregates. Currently, M2 and M3 are somewhat below the midpoints of their respective target ranges.

In the last several months, monetary policy has adopted a posture of watchful waiting as economic indicators have pointed increasingly toward recovery. With an eye to the usual lags in policy effects, this stance has been viewed as prudent to guard against the risk of adding excessive monetary stimulus to an economy that might already be solidly into recovery. Monetary policy during the first half of the year has had two jobs: first, to help bring the economy out of recession and, second, to avoid setting the stage for the next recession, which would follow if we allowed inflationary imbalances to develop in the economy.

The progress against inflation that has been set in motion must not be lost. Moreover, by consolidating and building upon the gains against inflation, we come that much closer to our longer-run goal of price stability. Inflation and uncertainty about inflation keep interest rates higher than they need be, distort saving and investment, and impede the ability of our economy to operate at its peak efficiency and to generate higher standards of living.

The Economic Outlook

It is this strategy that has been guiding monetary policy recently, and the effects of the strategy are reflected in the economic projections of the Federal Open Market Committee members and other Reserve Bank presidents. On the whole, their outlook is for underlying inflation to continue to slacken as the economy first recovers and then expands at a moderate rate through the end of next year.

For this year, while there remain—without question—frailties in the economy, economic activity appears on balance to be picking up in a fairly broad-based manner. The expectation that the turnaround in output is occurring, and that it will persist, is evident in the economic projections of the FOMC members and other Reserve Bank presidents. Their forecasts for real GNP growth over the four quarters of 1991 center on 1 percent or a shade below, implying growth over the remainder of this year that not only offsets the first-quarter decline in GNP, but also lifts output above its pre-recession peak by year-end.

Two fundamental questions may be posed with regard to this outlook for the rest of the year. The first is an inquiry into the potential sources of strength in the recovery—those forces that will be at work to pull the economy out of recession in a lasting fashion. We see a number of factors as having set the stage for the recovery: in particular, the reversal of the spike in world oil prices and the favorable effects of that reversal on real incomes; the conclusion of the Gulf War and the consequent rebound in consumer and business confidence; and, finally, the decline in short-term interest rates following our policy easings and the narrowing of risk premiums in financial markets. Against this backdrop, consumer expenditure growth seems to have turned positive again, along with real income; homebuilding has bottomed out and is providing some lift to overall growth; and orders for capital goods are pointing to a firming in demand that should be reflected in production and shipments in coming months.

The strongest force behind output growth in the near term, though, probably will be the behavior of inventories. Business inventories have been drawn down aggressively in recent quarters, and, with inventories now quite lean, sales increasingly will have to be satisfied out of new production. The inherent dynamics of an inventory cycle, as the drawdown ceases and eventually turns to rebuilding, likely will engender the bulk of the initial step-up in output. But there may be additional areas of demand that will impel the recovery; it is quite common at this point in the cycle for forecasts both to underestimate the strength of the recovery and to miss the forces that end up driving the expansion.

In fact, recessions typically have been followed by periods of appreciably stronger growth than that foreseen here. This raises the second question about the near-term forecasts, that is, whether they are optimistic enough. A number of considerations come to mind on that side of the issue. First, and in some sense most appealing, is the simple notion, which is lent some support by history, that relatively mild recessions beget relatively mild recoveries. And this recession, assuming it came to an end in the spring, seems to have been mild. Not only does it appear to have been marked by a considerably smaller contraction in real GNP and industrial production than the average postwar recession, it also was a bit shorter. In at least one respect, however, this recession was close to average, and that was in job losses, as firms cut payrolls fairly aggressively. Nevertheless, the unemployment rate did not rise as much or as high as was typical in the past.

Arguing against a rapid rebound in the economy are several other factors as well, including the lack of impetus from some sectors that contributed in earlier cycles. First, it has not been unusual to see some fiscal stimulus in the early stages of expansion in the past; this time, however, the Congress and the Administration have worked long and hard to make sure that genuine progress will be made in righting the structural imbalance in the budget, putting federal spending in real terms on a downward path. Nor is fiscal stimulus likely to emerge from the state and local sector, where deepening budget problems are constraining spending. A portion of the financial distress of localities can be traced to the softness in real estate markets feeding through to property tax receipts. The condition of the real estate market also is certain to restrain the pickup in construction that usually accompanies a recovery, with overbuilding in commercial real estate likely to damp activity in this area for some time to come. Finally, in the consumer area, expenditures are unlikely to grow more rapidly than personal income, as households avoid reducing their saving rate further from its already low level.

The expansion is seen as becoming more securely established next year, with real GNP growth strong enough to bring the unemployment rate dow ½ percentage point or more from its current level. Should the recovery unfold about as we expect, price pressures will remain muted and progress on inflation is likely. The expectations of FOMC members and other Reserve Bank presidents for inflation this year are centered in the neighborhood of 3½ percent, well down from the 6¼ percent rate of inflation experienced last year. Although the slowdown this year is exaggerated by the retreat in oil prices, a clear deceleration should be evident even abstracting from energy prices. That deceleration in the underlying trend is expected to continue next year, as well. However, the unwinding of the oil shock this year masks the improvement, so that the projection for the increase in overall consumer prices is about the same for 1992 as for 1991.

Ranges for Money and Debt Growth for 1991 and 1992

The FOMC viewed the near-term outlook for output and prices as generally favorable and consistent with growth of money and debt within the ranges that had been specified earlier in the year. Consequently, at its meeting earlier this month, the FOMC reaffirmed the 1991 ranges for money and debt growth. In addition, it was felt that the money ranges retained enough scope for policy to be responsive, should the economy stray substantially from its expected path over the remainder of the year. With M2 and M3 now well within their ranges, there remains ample room for money growth to change in the event policy needs either to ease in support of a faltering recovery or to tighten in reaction to an unexpected resurgence of inflation pressures.

Unlike the monetary aggregates, our latest reading on debt of the domestic nonfinancial sectors places it right at the bottom edge of its 1991 range. Its growth has been unusually low, and its position within the range is indicative both of the reduced demands for credit associated with the weak economy and of the restraint, on the part of borrowers and lenders, that has been evident in recent quarters. In these circumstances, the FOMC felt that lowering the monitoring range would be inappropriate and might falsely suggest a complacency on the part of policymakers about weakness in credit growth. Instead, maintaining the debt range unchanged underlines the implication that a further slowdown in this aggregate would warrant close scrutiny.

On a provisional basis, the FOMC extended the 1991 ranges for money and debt growth to 1992, with the understanding that there will be opportunities to reevaluate the appropriateness of these ranges before they come fully into play next year. The ranges were viewed as consistent with additional progress against inflation and with sustained economic expansion. Moreover, the path of no change appeared most sensible to the Committee at the current time of some uncertainty about the vigor and even the durability of the economic recovery, as well as about developments affecting the future of the thrift and banking industries.

This uncertainty about the credit intermediation process is one of the factors that could possibly make movements in M2 somewhat difficult to interpret in the short run, but I would emphasize that we expect the aggregate to remain a stable guide for policy over the longer term. The relationship between M2 and nominal income has been one of the more enduring in our financial system. Since the founding of the Federal Reserve, nominal GNP and M2 have grown, on average, at almost precisely the same rate. Presumably, this parity reflects an underlying demand for liquidity on the part of businesses and consumers that is associated with a given level of spending and wealth. This demand is likely to persist, though the financial structures that supply the liquidity may change.

Changing Patterns of Financial Intermediation and Debt Accumulation

Recently, patterns of financial intermediation have been changing, and there are signs that patterns of credit usage in general have been changing as well. It is difficult to know which of these developments will show some permanence and which will prove ephemeral. But some of the recent changes have been striking and have affected a number of the financial variables that the Federal Reserve routinely monitors in an effort to glean information about the health of the economy, the soundness of the financial system, and the appropriateness of current monetary policy. I would like to address several aspects of these recent developments in the remainder of my remarks today.

First, at the most aggregate level, the ratio of domestic nonfinancial sector debt to nominal GNP, which soared in the 1980s, is beginning to show signs of flattening out. With the federal government's borrowing lifted by the effects of the recession and payments related to deposit insurance, these signs have been evident so far only in the other sectors. While the changes in behavior may, in part, reflect cyclical factors at work, a longer-term trend also may be emerging. And this trend, if it develops fully, would represent a return to the pattern evident in earlier postwar decades. In that case, it would be the 1980s, with their burgeoning federal deficits and massive corporate restructurings, that would appear the aberration. The deregulation, technological advances, and financial innovations that came at an accelerated pace in the 1980s lowered the cost of borrowing for many and probably raised the equilibrium ratio of debt to net worth for a wide range of economic entities. A temporary surge in borrowing was implied in the course of this transition from one equilibrium to another.

A tapering-off of that surge would then be expected as the new equilibrium was approached, and this may be what we currently are witnessing. The new equilibrium debt-to-income ratio may even be below the current level, implying the possibility of sluggish debt growth for some time. If these sorts of adjustments were in train, the slow debt growth associated with them should not be read as implying that credit was insufficient to support satisfactory economic performance.

A number of considerations point in the direction of restructuring of balance sheets. The forces that appear to be restraining the demand for credit can be generally categorized as less "grossing up" of balance sheets and less substitution of debt for equity. During the 1980s, there was a great deal of this "grossing up" of balance sheets, as credit financed more purchases both of physical assets and of financial assets. As far as physical assets are concerned, the 1980s saw some strong spending on consumer durables and nonresidential structures; spending on physical assets, such as these, appears more often to be financed with debt than is spending on most other types of goods and services. Now, with stocks of those assets already built up and with tax law changes that have made it less attractive in many cases to borrow to finance their purchase, credit demands are likely to remain relatively damped.

The high interest rates of the late 1970s and early 1980s spurred increased financial innovation and extensive deregulation, helping to bring businesses and consumers increasingly into more complex financial dealings. The state and local sector built up a large stock of financial assets, and the household sector acquired assets from the wider array of instruments available. Moreover, household borrowing behavior was shaped importantly by the rising capital gains available on residential real estate over this period. As house prices escalated, mortgage debt on existing homes increased, both as capital gains were realized in home sales and as unrealized gains were tapped through the use of second mortgages and, more recently, home equity lines. In this process, home owners were able to redirect a portion of these capital gains toward other assets or current consumption.

Over the decade, the financial services industry grew at an extraordinary rate, in part by creating debt instruments seemingly tailored to every need and financial assets for any portfolio. While households took advantage of a number of these new instruments, the bulk of them were directed toward business. Mergers and acquisitions took off, financed essentially by debt, resulting in net retirements of equity that averaged nearly $100 billion annually between 1984 and 1989.

More recently, with debt levels relatively high and lenders less eager to extend credit, markets have changed. One aspect of this change shows up dramatically in data for the second quarter, where equity issuance by nonfinancial corporations is estimated to have exceeded equity retirements for the first time in eight years, removing this element behind the buildup of debt. While much of the weakness in credit demand at present reflects cyclical influences, borrowers likely will continue to shy away from the heavy expansion of debt seen in the 1980s.

On the supply side of the credit market, perhaps the major factor at work in creating a break with the behavior of the 1980s has been the adverse consequences of that behavior. It is now clear that a significant fraction of the credit extended during those years should not have been extended. We need merely look at the recent string of defaults and bankruptcies, and the condition of many of our financial intermediaries to confirm this impression.

In a sense, this process may have been very nearly inevitable. With the financial system groping toward a new equilibrium, the likelihood of mistakes was high. Laxity by lenders abetted the spiral of debt, and we regulators were too often slow to intervene. Now, financial institutions, regulators, and taxpayers are facing the wrenching unwinding of those lending decisions. A key lesson to be learned is how important it is to avoid these costly adjustments in the future and that this can only be done by avoiding a return to such financial laxity.

Going forward, we likely will see a continuation of the ''credit correction'' now under way. One aspect of this correction is the increased attention paid by regulators and the financial markets to the capital positions of financial intermediaries. The more prudent approach to capitalization and lending decisions is overwhelmingly a healthy development that ultimately will result in strengthened balance sheets for the nation's financial institutions and more assurance of stability of the financial system.

In certain areas, however, the credit retrenchment appears to have gone beyond a point of sensible balance. In some cases, lender attitudes and actions have been characterized by excessive caution. As a result, there doubtless are creditworthy borrowers that are unable to access credit on reasonable terms. Even in the obviously troubled real estate area, new loans are arguably too scarce, in some cases intensifying the illiquidity of the market for existing properties. To an extent, the scarcity of some types of loans may reflect the efforts of individual financial institutions to reduce the share of their assets in a particular category, such as commercial mortgages. While a single bank may be able to do this without too much trouble, when the entire industry is trying to make the same balance sheet adjustment, it simply cannot be done without massive untoward effects. Instead, it may be in the banks' self-interest to make the adjustment in an orderly manner over time. Regulatory efforts to address credit availability concerns continue.

Credit conditions remain tight in some sectors, but in others the situation appears to have improved considerably since our last Report in February. To chronicle briefly what we know about credit supply conditions at present: In financial markets generally, risk premiums and spreads between yields on different types of debt have declined substantially this year as investor attitudes have improved. In part reflecting this narrowing, corporate bond offerings surged over the first half of the year. Banking firms, too, gained increased access to capital markets, leaving them in a better position to lend as credit demands begin to pick up in the recovery. Indexes of bank stock prices rose much more rapidly than the stock market as a whole, bringing the average market value of shares in the top fifty bank holding companies back up to around their book value. Yield spreads on bank-related debt obligations narrowed sharply over the first half of the year, prompting considerable issuance.

Thus far, however, lending by commercial banks has remained quite weak. To the extent we can judge, this appears primarily to reflect weak credit demand, as is typical at this point in the business cycle. Nonetheless, supply restrictions remain a problem. This so-called ''credit crunch'' owes importantly to financial institutions' efforts to build capital to meet the demands of both the market and the regulators. Information on lending terms, however, suggested little further tightening over the spring.

Not only the behavior of the debt aggregate itself, but also the avenues through which the debt flows, represent something of a break with the past. The recent decline in the importance of depository institutions as intermediaries, when measured by the credit they book, is quite striking. While this predominantly reflects the contraction of the thrift industry, banks, too, have contributed by growing only slowly. Over time, other financial institutions have provided more close substitutes for banking services, and the profitability of the banking industry suffered over the last decade or so from a decline in loan quality. Moreover, recent emphasis on higher capital ratios and higher deposit insurance premiums should affect this trend as well.

Even as the economy has firmed, financial flows through depository institutions have remained weak. Some lag is typical. Indeed, in the case of business loans, there is enough of a regularity that they are included in the Department of Commerce's Index of Lagging Economic Indicators. But lending to businesses has been unusually weak for some time now and the outlook is for a rather modest upturn when it comes. At the same time that decisions to purchase goods and services are made, decisions about the financing of those purchases are usually being made. Increasingly, it appears that those decisions are not being reflected in credit on the books of depository institutions. Banks still may be involved, however. They may, for example, provide letters of credit or arrange financing through a special-purpose corporation. Mortgage and consumer debt may pass through the balance sheets of these intermediaries only briefly, as it is increasingly being securitized and sold into capital markets. As banks make further strides in bolstering their capital positions, however, they will become better able to take advantage of opportunities to add profitable loans to their balance sheets. While the role of the banking industry has been changing, its importance in the financial system and the economy remains assured.

In sum, the financial system in this country is changing, and it is changing rapidly. Technology, regulatory initiatives, and market innovations are changing many dimensions of the financial system. The relationships between borrowers and lenders, between risk and balance-sheet exposure, and between credit and money are being altered in profound ways. In response, we must understand the nature of these changes, their permanence, their limitations, and their possible implications for the economy and monetary policy. And we must ensure that the stability of the financial system is protected as changes occur, for a sound financial system is an essential ingredient of an effective monetary policy and a vital economy.

1991 MONETARY POLICY OBJECTIVES

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

July 16, 1991

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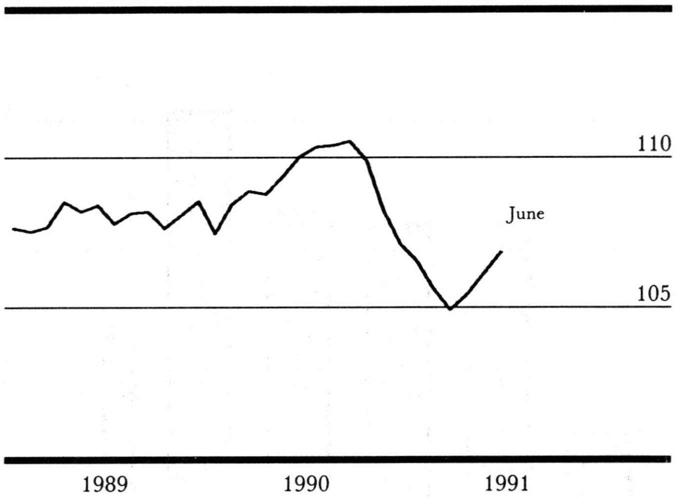
Monetary Policy and the Economic Outlook for 1991 and 1992

When the Federal Reserve presented its last monetary policy report to the Congress, in February of this year, the economy was still in a downswing that had been precipitated by Iraq's invasion of Kuwait in August 1990 and the associated spike in oil prices. To be sure, several developments early in the year had created conditions that promised to help foster a turnaround in the economy: Not only had oil prices reversed most of their earlier runup, but monetary policy had been eased substantially in the final months of 1990 and the early part of this year. However, the economy continued to weaken for a time, and policy was eased further into the spring, with the objective of ensuring a satisfactory recovery.

Recent evidence suggests that a pickup in activity probably is now under way. Much of the uncertainty that had depressed business and consumer sentiment was removed by the successful end of hostilities in the Persian Gulf. The resulting improvement in confidence, combined with the boost to real purchasing power provided by the retreat in oil prices, raised consumer spending on balance over the late winter and spring. These same factors, as well as lower mortgage rates, also have spurred a gradual recovery in the housing sector. Reflecting the stimulus from housing and consumer demand, along with the continued growth in U.S. exports, industrial production turned up in April and has advanced appreciably since then; in addition, labor demand showed signs of stabilizing during the spring.

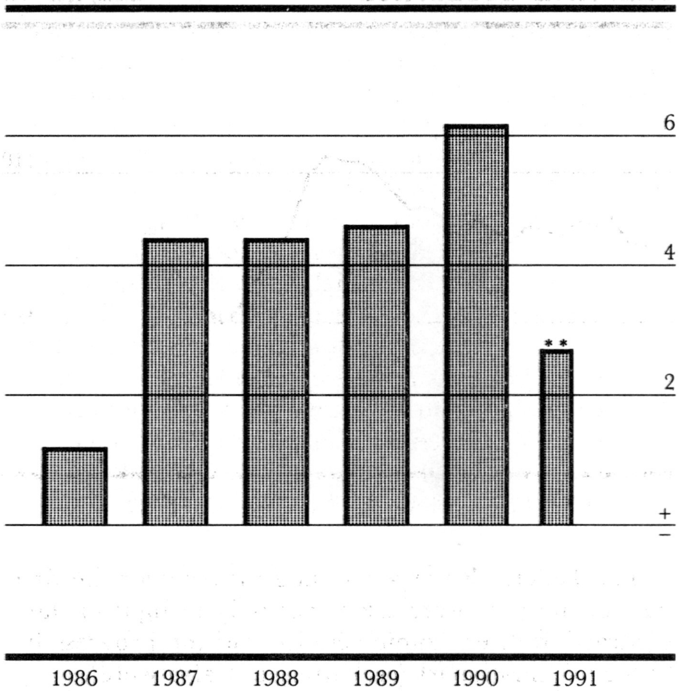
As anticipated earlier this year, inflation has slowed from its pace in 1990. Retail energy prices came down substantially during the first half of the year, and the rise in consumer food prices moderated after several years of relatively large increases. More generally, the softness of labor and product markets has attenuated price pressures for a range of goods and services. This downdrift in "core" inflation was difficult to discern earlier in the year because of a bunching of price increases in January and February; however, most of the significant increases in those months either did not continue or were reversed.

Industrial Production Index, 1987 = 100



The Federal Reserve's easing moves over the first part of the year were taken not only in light of the contraction of economic activity and the progress in reducing inflationary pressures, but also were prompted by the continued slow growth of the monetary aggregates early in the year and continuing credit restraint by banks and other intermediaries. Reserve market conditions were held steady after April, however, as evidence began to accumulate that the economy was on track toward recovery. Reflecting the Federal Reserve's policy actions and generally weak credit demands, short-term interest rates declined appreciably during the first half. Longer-term rates, which had moved down markedly in the final months of 1990, were mixed over the first half; with bond market participants focusing on signs of an emerging recovery, Treasury bond yields rose a bit, while rates on bonds issued by businesses fell as risk premiums narrowed sharply. In the stock market, share prices have registered sizable increases since January, and broad indexes remain within a few percent of the all-time highs set in the spring. Meanwhile, the value of the dollar has climbed substantially on foreign exchange markets, supported by the successful conclusion of military operations in the Gulf, expectations of a recovery in the U.S. economy, and by economic developments in Germany and political difficulties in the Soviet Union.

Consumer Prices* Percent change, Dec. to Dec.



*Consumer Price Index for all urban consumers.
**Percent change from Dec. 1990 to May 1991, annual rate.

Monetary Objectives for 1991 and 1992

At its meeting earlier this month, the Federal Open Market Committee (FOMC) reaffirmed its previously established ranges for money and credit for 1991. The target range for M2 had been lowered in February to 2½ to 6½ percent from the 3 to 7 percent range that had been in place for 1990. To date this year, M2 has grown at an annual rate of a little less than 4 percent, placing it well within the target range for 1991 as a whole. This, in effect, leaves the Committee some room to maneuver as events unfold in the coming months, while remaining within the annual range. The potential need for such room arises in part in connection with the significant uncertainties attending the prospects for the velocity of M2. If, for example, the public's demand for M2 balances should be damped by moves among depository institutions to lower deposit rates (in response to earlier declines in market yields and to higher insurance premiums), then velocity might tend to be stronger than otherwise would be the case and less M2 growth would be required to support a given rate of GNP increase. If, on the other hand, institutions were to become more aggressive in bidding for loanable funds in the retail deposit market, and thus the public began to shift its portfolio back in favor of M2 assets, then velocity could weaken and faster M2 growth might be required. The Committee expects that the current annual growth range will permit it to deal with such velocity-altering disturbances in money supply and demand while it fosters financial conditions conducive to moderate economic growth and further progress toward price stability.

The 1 to 5 percent range for M3 adopted in February took account of the expected continued contraction in the thrift industry and associated redirection of credit flows away from depository institutions. The assets of thrift institutions are expected to shrink further in the second half, owing in large part to closures by the Resolution Trust Corporation (RTC). Issuance of large time deposits by branches and agencies of foreign banks has moderated, but domestic banks may have a greater appetite for funds in the second half as sound lending opportunities increase with the projected improvement in the economy.

Even though growth of the aggregate debt of domestic nonfinancial sectors at midyear was at the lower end of its current 4½ to 8½ percent monitoring range, the Committee anticipates that the debt measure will end the year well within that range. Stronger private credit demands are expected to arise as the economy grows, and federal borrowing will increase to finance stepped-up RTC activity. However, debt growth is likely to continue to be damped by the shift in attitudes about leveraging.

Ranges for Growth of Monetary and Credit Aggregates[1]

(Percent Change, Fourth Quarter to Fourth Quarter)

	1990	**1991**	**Provisional for 1992**
M2	3 to 7	2½ to 6½	2½ to 6½
M3	1 to 5	1 to 5	1 to 5
Debt	5 to 9	4½ to 8½	4½ to 8½

In setting provisional ranges for 1992, the Committee chose to carry forward the 1991 ranges for the monetary aggregates and for debt. Recognizing that the ranges had been reduced significantly over the past few years, the Committee at this time believes that expansion of money and debt in 1992 within the current ranges probably would be consistent with consolidating and extending the gains that have been made to date toward lower inflation, while providing sufficient liquidity to support a sustainable expansion of economic activity. The ranges will, of course, be reevaluated next February in light of intervening economic and financial events. The Committee will want to update its assessment of the underlying tendencies in the economy as well as in the relations between money and debt expansion and economic performance. Although the initial indications of money and credit ranges that are given in July always are tentative, flexibility seems all the more warranted in the current circumstances, with the economy apparently at a cyclical turning point and the financial system being buffeted by fundamental change.

Economic Projections for 1991 and 1992

The target ranges for the monetary aggregates and debt have been selected with the objective of supporting a sound economic expansion accompanied by declining inflation—a pattern the Board members and Reserve Bank presidents generally expect to prevail over the coming year and a half. Most forecast that real GNP will grow 3/4 to 1 percent over the four quarters of 1991; given the decline during the first quarter, this central tendency range for 1991 as a whole implies an appreciable pickup in activity over the remainder of the year. The projections of growth in real GNP over the four quarters of 1992 have a central tendency of 2¼ to 3 percent.

In appraising the near-term outlook, the FOMC participants have placed considerable weight on the apparent absence of inventory overhangs in most sectors. Accordingly, the recent firming of aggregate final demand is expected to bring a halt soon to the inventory drawdowns that persisted into the second quarter. The resulting swing in the pace of inventory investment is expected to boost domestic production considerably over the rest of 1991. As typically occurs in the initial stage of a recovery, much of this rise in output is expected to reflect gains in the productivity of existing workers, rather than a marked pickup in employment. Thus, the Board members and the Bank presidents project only modest progress in reducing unemployment over the second half of the year; the central tendency for the civilian jobless rate in the fourth quarter is 6¾ to 7 percent.

The pace of expansion may moderate somewhat in 1992, as the initial impetus from the inventory swing subsides and gains in production track the growth in final demand more closely. The advance in real GNP expected for 1992, though subdued relative to that in the early part of most previous expansions, is anticipated to reduce the margin of slack in the economy over the year. The central tendency of the civilian unemployment rate projected for the fourth quarter of 1992 is 6¼ to 6½ percent, roughly 1/2 percentage point below the level expected in the fourth quarter of this year.

Several factors lie behind the expectation of a relatively mild upswing in economic activity. In real estate markets, the persistent overhang of vacant space for many types of buildings, along with continued caution on the part of lenders, likely will limit the amount of new construction. In addition, fiscal policy will remain moderately restrictive owing to the federal budget agreement reached last fall and efforts by state and local units to correct serious imbalances in their budgets; although this fiscal restraint ultimately will strengthen the U.S. economy by boosting domestic saving and investment, its near-term effect will be to hold down aggregate demand. Further, with the personal saving rate already at a low level and some households saddled with heavy debt burdens, consumer spending is projected to grow at a relatively slow pace. Finally, the appreciation of the dollar this year has offset some of the previous declines in relative prices of U.S. goods in international markets, thus limiting the contribution that can be expected from the external sector.

By adopting policies intended to put the economy on a path of moderate, sustainable growth, the Board members and Reserve Bank presidents believe that it will be possible to achieve meaningful progress in reducing inflation over the remainder of this year and into 1992. The central tendency of the forecasted rise in the total consumer price index (CPI) is 3¼ to 3¾ percent over the four quarters of 1991 and 3 to 4 percent over 1992, well below the 6¼ percent rise over the four quarters of 1990. In each of the prior three years, 1987-89, the CPI rose about 4½ percent.

The common midpoint of the forecast ranges for CPI increases in 1991 and 1992, 3½ percent, masks the downtrend in core inflation anticipated over the next year and a half. In particular, most of the slowing of inflation observed thus far this year has reflected the sharp drop in energy prices and a move toward smaller increases in food prices; excluding food and energy, the deceleration in the CPI so far has been relatively small. However, with the tempering of labor-cost increases now under way and the reduced pressure on plant utilization, core inflation is expected to recede significantly in coming quarters. As these declines become widely perceived, expectations of inflation should moderate, reinforcing the tendencies toward deceleration. By reducing and ultimately eliminating the distortion to resource allocation stemming from ongoing, generalized price increases, a monetary policy aimed at achieving price stability over time will enhance the economy's potential to grow and thereby raise standards of living.

Economic Projections for 1991 and 1992

		FOMC Members and other FRB Presidents		Administration
1991		Range	Central Tendency	
Percent change, fourth quarter to fourth quarter:	Nominal GNP	3¾ to 5¾	4½ to 5¼	5.0
	Real GNP	½ to 1½	¾ to 1	0.8
	Consumer price index	3 to 4½	3¼ to 3¾	3.4[1]
Average level in the fourth quarter, percent:	Civilian unemployment rate	6½ to 7	6¾ to 7	6.7[2]
1992		Range	Central Tendency	
Percent change, fourth quarter to fourth quarter:	Nominal GNP	4 to 6¾	5½ to 6½	7.5
	Real GNP	2 to 3½	2¼ to 3	3.6
	Consumer price index	2½ to 4¼	3 to 4	3.9[1]
Average level in the fourth quarter, percent:	Civilian unemployment rate	6 to 6¾	6¼ to 6½	6.3[2]

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

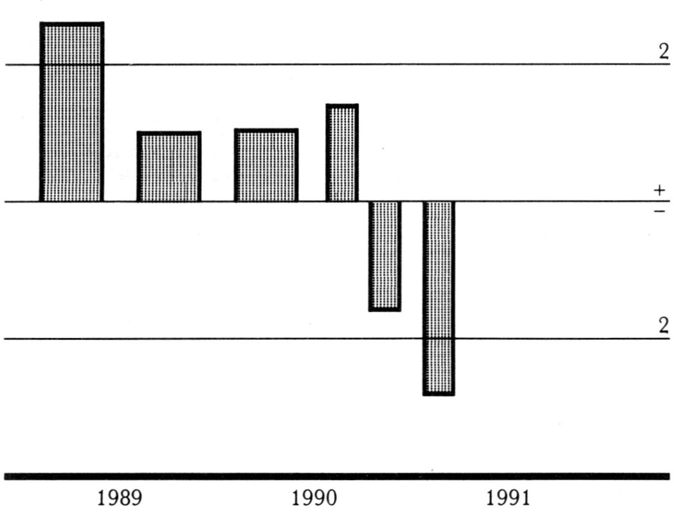
2. Percent of total labor force, including armed forces residing in the United States.

The Performance of the Economy during the First Half of 1991

The magnitude and length of the recent recession still are not known with certainty, but the decline in real GNP appears to have been considerably smaller than the average decline during the previous post-World War II recessions; for the industrial sector alone, production dropped 5 percent between the peak in September of last year and the low point in March, compared with an average fall-off of nearly 10 percent during previous recessions. The recent contraction also seems to have been relatively short by historical standards. Aggregate job losses, however, were close to the average in previous recessions, suggesting that firms cut payrolls vigorously given the fairly shallow drop in real activity.

Real GNP

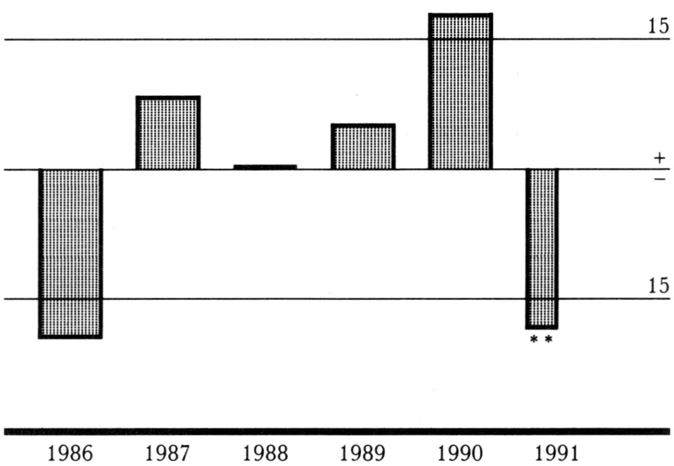
Percent change, annual rate



Consumer price inflation, which exceeded 6 percent last year, slowed to a 2¾ percent annual rate over the first five months of 1991. Consumer energy prices fell sharply early this year, after soaring during the second half of 1990. In addition, the rate of increase in food prices has retreated this year from the pace registered during the preceding three years.

Consumer Energy Prices*

Percent change, Dec. to Dec.



*Consumer Price Index for all urban consumers.
**Percent change from December 1990 to May 1991, annual rate.

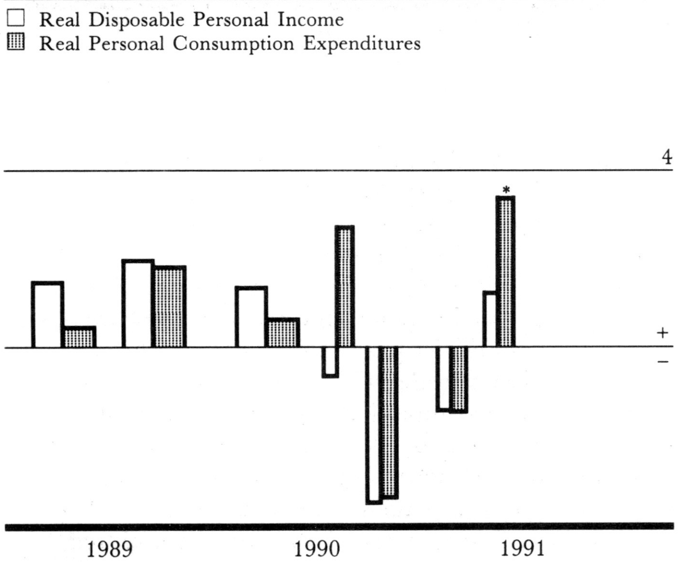
Apart from food and energy, price increases were large early in the year, but have been more moderate in recent months. On balance, over the first five months of 1991, this portion of the CPI increased a bit more than 5 percent at an annual rate, about 1/2 percentage point below the trend rate of increase as of last summer. In part, the recent headway made on inflation reflects the reduction in labor-cost pressures that accompanied the rise in unemployment. As measured by the employment cost index, compensation per hour increased at an average annual rate of 4¼ percent over the second half of 1990 and the first quarter of this year, compared with the 5¼ percent (annual rate) rise over the first half of 1990.

The Household Sector

Consumer spending was an area of notable weakness last fall and early this year, largely in response to a substantial decline in real income. Real consumer spending fell at a 1½ percent annual rate in the first quarter, after a 3½ percent (annual rate) decline in the fourth quarter of 1990. However, in February, real income turned up and consumer confidence rebounded late in the month with the end of the Gulf war; both developments bolstered consumer spending. As a result of the spending gains that began in February, the average level of outlays in April and May stood considerably above the first-quarter average.

Income and Consumption

Percent change annual rate



*Percent change from 1991 Q1 to average of April and May 1991, at an annual rate.

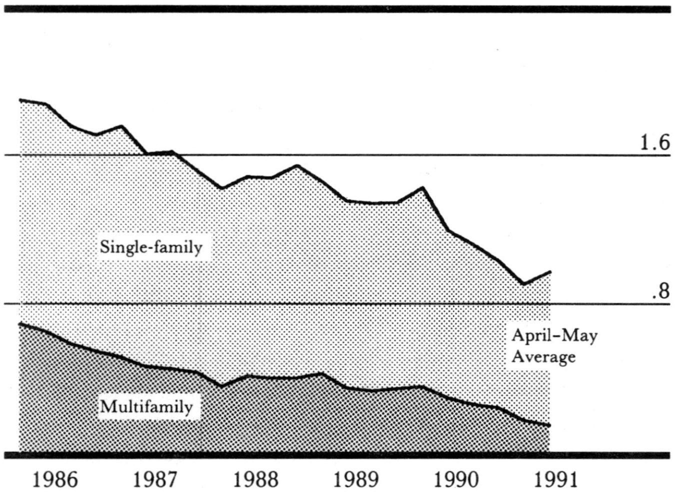
Among the major components of consumer spending, outlays were cut back sharply for motor vehicles and other durable goods as the recession unfolded. Substantial cuts also were made in purchases of nondurable goods. In contrast, consumer outlays for services trended up at a pace only slightly below that registered during the first three quarters of 1990. Since the January trough in total consumer outlays, purchases of both durable and nondurable goods have turned up. In particular, as of May, real consumer purchases of motor vehicles had risen about 8 percent from the depressed January level.

Although consumers cut back spending, they cushioned some of the effect of weak income by reducing their savings. After averaging about 5 percent over the first half of 1990, the personal saving rate dropped to 4.2 percent in the third quarter and remained at that level through the first quarter of this year. The decline in the saving rate occurred despite some deterioration, on net, in wealth positions during the second half of 1990, which reflected the softening of house prices and losses in the stock market. The average level of the saving rate dropped another notch in the spring, to about 3¾ percent. The saving rate is now at the lowest level since late 1987, and it would not be surprising if gains in consumption lagged behind those for income in the near term as households worked to rebuild net worth through increased saving.

Residential construction activity, which had been trending lower since 1986, slumped further in the second half of last year. However, the market for single-family homes bottomed out in January and has staged a mild recovery since then, spurred by a firming of demand. Several factors account for the pickup in demand, including the decline in home prices to more affordable levels in a number of markets, improved prospects for employment and income, and some reduction in mortgage rates from those prevailing in the middle of last year. Despite continued caution on the part of lenders in granting land acquisition and construction loans, the quantity of financing available appears sufficient, on balance, to support a further recovery in this sector. In contrast, the market for multifamily housing has continued to weaken this year. Starts in May were at the lowest monthly level since the 1950s.

Private Housing Starts

Annual rate, millions of units, quarterly average



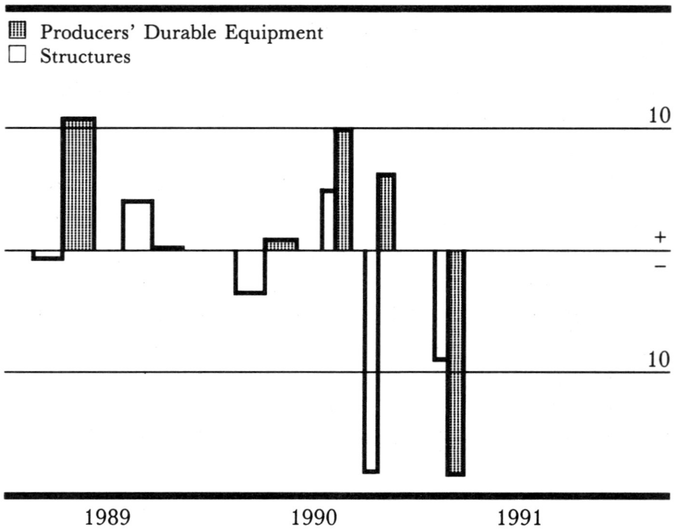
The Business Sector

During the latter part of 1990 and the first quarter of this year, the business sector experienced considerable stress. Demand for business output was depressed both by the loss of domestic purchasing power and by the enormous uncertainties created by the situation in the Persian Gulf. In response to the slump in demand, industrial production turned downward last October; it continued to fall through March. The combination of plummeting sales and rising energy prices caused profit margins, which were already slim, to shrink further in most industries during the second half of 1990. In the first quarter, before-tax profits from current operations for U.S. corporations edged down from the low fourth-quarter level.

Business spending for fixed investment was flat in real terms during the fourth quarter of last year and dropped sharply during the first quarter of this year. Spending for new equipment typically does not turn up until several months after the end of a recession, and the lag is often substantially longer for construction outlays. As yet, there is little sign of a rebound in spending for either equipment or nonresidential structures. Nonetheless, shipments of industrial equipment and other nondefense capital goods—a coincident indicator of equipment spending—have stabilized in recent months.

Real Business Fixed Investment

Percent change annual rate



An unusual feature of the recent recession was the speed with which producers cut output in order to avoid a buildup of inventories. The promptness of this adjustment likely reflected a combination of factors. The downturn in final demand was widely anticipated, and some producers cut output preemptively, rather than risk being saddled with excessive stocks. In addition, improved systems for monitoring and controlling inventories have been installed in recent years, which enabled firms to react quickly to signs of slowing demand. Further, the relatively heavy debt burdens in the corporate sector created substantial financial pressures for many firms and focused attention on the need to cut costs.

Accordingly, inventories were run off at a rapid clip beginning late last summer. Automakers slashed production and inventories particularly aggressively. Despite production cutbacks by the automakers and other producers, the inventory-to-sales ratio for total manufacturing and trade moved up through January. However, by May, the ratio had retraced most of the runup that began with the onset of the recession, reflecting the continued liquidation of stocks and an upturn in sales. Inventories in most industries appear now to be reasonably well aligned with sales, and output has begun to rise with the expansion of final demand. Orders for a range of manufactured goods firmed in April and May, pointing to a further pickup in production during the summer.

The Government Sector

The federal budget deficit over the first eight months of fiscal year 1991 was $175 billion, compared with the $151 billion deficit recorded during the same part of fiscal year 1990. The deficit during the current fiscal year has been boosted considerably by the slowdown in economic activity, and this cyclical increase has masked the fiscal restraint imposed by last autumn's budget agreement. On the revenue side, federal tax receipts have been held down by the anemic growth of nominal income since last fall. The slowdown in activity also has raised the deficit by increasing outlays for income-support programs such as unemployment insurance, food stamps, and Medicaid. These effects of the contraction have been offset, to some degree, by the easing of short-term interest rates, which has restrained the growth of interest payments on the federal debt.

Federal purchases of goods and services, the part of federal spending that is included directly in GNP, rose 5¼ percent in real terms over the four quarters of 1990. This increase reflected the fourth-quarter rise in defense purchases to support operations in the Persian Gulf, as well as increases over the year in such nondefense programs as law enforcement, space exploration, and health research. In the first quarter of 1991, real defense purchases moved above the already high fourth-quarter level, while nondefense purchases fell somewhat on net, pushed down by sales of oil from the Strategic Petroleum Reserve. Over the rest of 1991, fiscal policy likely will be a restraining influence on the economy, owing to the spending limits and tax increases mandated by last fall's budget agreement.

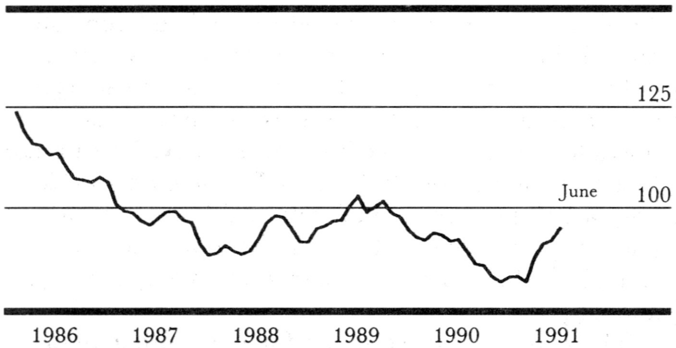
The fiscal position of state and local governments has remained extremely weak in recent quarters. The deficit in operating and capital accounts (that is, the deficit excluding social insurance funds) stood above $40 billion at an annual rate in both the fourth quarter of 1990 and the first quarter of 1991, after holding at a $30 billion rate for a year.

The External Sector

Over the first half of 1991, the foreign exchange value of the dollar appreciated about 15 percent, on balance, in terms of the currencies of the other Group of Ten (G-10) countries. The net appreciation over this period reversed about two-thirds of the decline in the dollar that had occurred between the middle of 1989 and the end of 1990. On a bilateral basis, the dollar has appreciated about 20 percent this year against the German mark and by similar amounts against the European currencies associated with the mark. The weakness of these currencies partly reflects economic difficulties in Germany and the spillover effects of the turmoil in the Soviet Union and Yugoslavia.

Foreign Exchange Value of the U.S. Dollar*

Index, March 1973 = 100

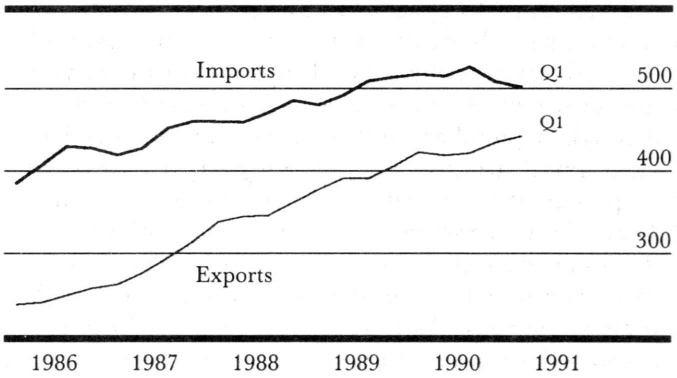


*Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of other G-10 countries. Weights are 1972–76 global trade of each of the 10 countries.

The overall strengthening of the dollar this year has acted to restrain prices for non-oil imports. Over the first quarter of 1991, these prices rose at a 2½ percent annual rate, less than half the rate of increase recorded between June and December of 1990; non-oil import prices then fell during April and May, more than reversing the entire first-quarter rise. The price of imported oil, which surged between August and October of last year, has since retraced most of the rise induced by the Iraqi invasion of Kuwait. Taken together, these two developments contributed significantly to the restraint on domestic inflation.

U.S. Real Merchandise Trade

Annual rate, billions of 1982 dollars



Real merchandise imports declined in the first quarter to a level about 5 percent below that in the third quarter of 1990, with the drop largely reflecting the weakness in domestic demand. Preliminary data for April show some increase in non-oil imports, a pattern that is likely to continue with the apparent firming of domestic activity. The quantity of oil imports—which plunged after the spurt in oil prices last summer and remained relatively low early this year—has moved back up in recent months, reflecting efforts to rebuild U.S. petroleum inventories.

Merchandise exports continued to move higher through the spring, a factor that clearly tempered the output loss in manufacturing after the oil shock last year. The competitive position of U.S. companies has benefitted, at least until quite recently, from the substantial drop in the dollar over 1990 and the latter part of 1989. However, recessions in the economies of some of our major trading partners, especially Canada and the United Kingdom, have offset part of the stimulus to U.S. exports provided by the rapid growth in such countries as Germany, Japan, and Mexico.

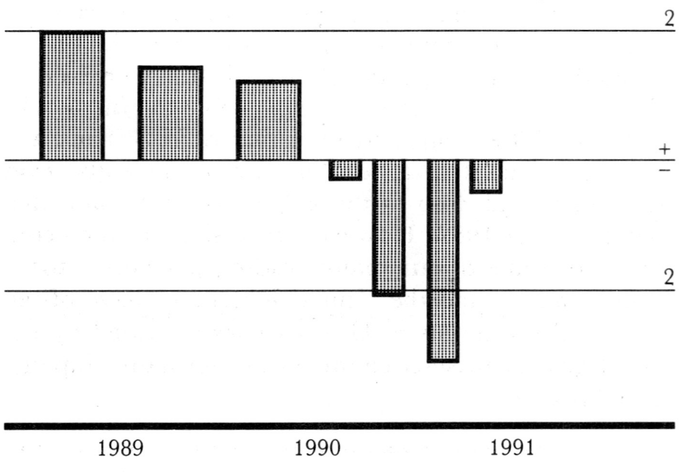
Labor Markets

Labor demand appears to have stabilized after contracting sharply during the latter part of 1990 and the early part of this year. Employment on private nonfarm payrolls peaked last June, edged lower through September, and then fell substantially in each month from October through April. However, employment on private nonfarm payrolls rose in May, the first increase since the middle of 1990. Although part of this gain was reversed in June, firms continued to lengthen the average workweek of their employees. This pattern of cautious hiring combined with an extension of the workweek is common in the early stage of a recovery. The civilian unemployment rate continued to inch up over the second quarter, but increases in the jobless rate often occur during the first several months of a recovery.

Payroll Employment

Net change, millions of persons, annual rate

Total Private Nonfarm



Price Developments

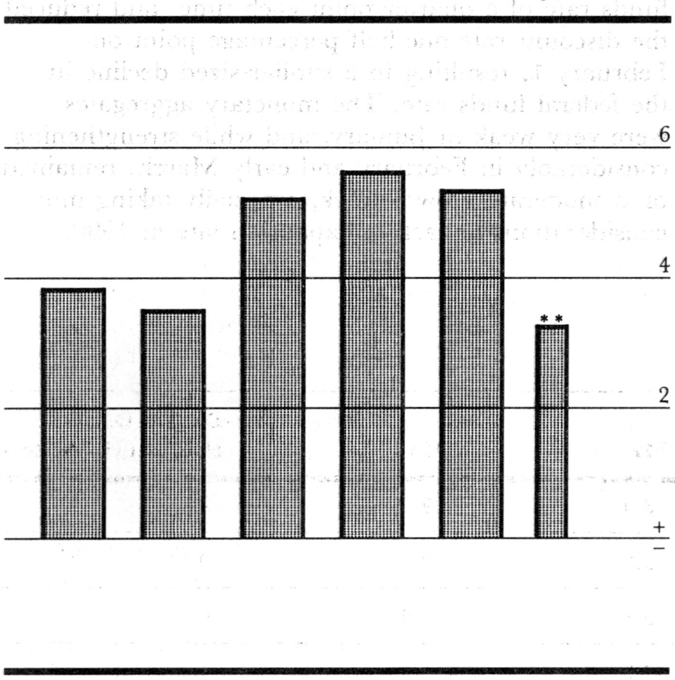
Inflation pressures have eased somewhat this year. The bulk of last year's spike in energy prices has been retraced, and the rate of increase in food prices has slowed. In addition, the margin of slack in labor and product markets that emerged during the recession is placing downward pressure on price increases for other goods and services; this trend toward slower "core" inflation, however, was obscured early in the year by a number of price increases that either were one-time events or have since been reversed.

Energy prices for consumers have followed the movements in world oil prices since last summer. The CPI for energy peaked in November 1990 at a level 15 percent above that in July, pushed up by the sharp rise in oil prices that occurred between August and October. Consumer energy prices then fell sharply through the first quarter of this year. By April, the decline in crude oil prices had been fully passed through to energy prices at the retail level.

Increases in consumer food prices this year have slowed from the 5¼ to 5½ percent range that prevailed over the preceding three years. During the first five months of 1991, the CPI for food rose at only a 3¼ percent annual rate, held down in large part by price declines for dairy products and by roughly stable prices on balance for meat, poultry, and eggs.

The consumer price index for items other than food and energy rose sharply during January and February, but the jumps in those months reflected a number of one-time or transitory increases. Higher federal excise taxes went into effect on cigarettes and alcoholic beverages, raising consumer prices for both items; these tax hikes supplemented the increases in sales and excise taxes that a number of states have imposed over the past year. More generally, the spurt in oil prices last fall spilled over through early

Consumer Food Prices* Percent change, Dec. to Dec.



*Consumer Price Index for all urban consumers.
**Percent change from Dec. 1990 to May 1991, annual rate.

1991 to prices for a wide range of non-energy goods and services. However, these factors boosting inflation proved to be short-lived. After the large increases in January and February, the CPI excluding food and energy rose at just a 2¼ percent annual rate between February and May.

The uneven pace of inflation this year has tended to obscure trends in the general level of retail prices. Nonetheless, there is little doubt that the underlying pace of inflation has moderated since last year. The twelve-month change in the CPI excluding food and energy—which held around 4½ percent throughout 1988, 1989, and the early part of 1990—moved up to about 5½ percent in August 1990. By May of this year, the twelve-month change in this index had fallen back to 5.1 percent.

Monetary and Financial Developments during the First Half of 1991

The Implementation of Monetary Policy

The Federal Reserve adjusted policy in three separate steps in the first quarter of the year, extending the series of moves initiated in the final months of 1990. Amid signs of continuing steep declines in economic activity and abating inflation pressures, the Federal Reserve eased reserve provision through open market operations in January and again in early March, leading to a decline in the federal funds rate of a quarter point each time, and reduced the discount rate one-half percentage point on February 1, resulting in a similar-sized decline in the federal funds rate. The monetary aggregates were very weak in January, and while strengthening considerably in February and early March, remained on a moderate growth track, especially taking into consideration the lack of expansion late in 1990.

Growth of Money and Debt (Percent change)

		M1	M2	M3	Debt of Domestic Nonfinancial Sectors
Annually, fourth quarter to fourth quarter	1980	7.4	8.9	9.5	9.4
	1981	5.4 (2.5)*	9.3	12.3	10.1
	1982	8.8	9.1	9.9	9.1
	1983	10.4	12.2	9.8	11.1
	1984	5.4	8.0	10.7	14.2
	1985	12.0	8.7	7.6	13.1
	1986	15.5	9.2	9.0	13.2
	1987	6.3	4.3	5.8	9.7
	1988	4.2	5.2	6.3	9.2
	1989	0.6	4.7	3.6	7.7
	1990	4.2	3.8	1.7	6.7
Quarterly 1991 *(annual rate)*	Q1	5.9	3.4	4.0	4.8
	Q2	7.4	4.6	1.8	4.2
Semiannually 1991, fourth quarter to second quarter *(annual rate)*	H1	6.7	4.0	2.9	4.5

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

Other short-term rates generally fell about a percentage point over this period. The commercial bank prime loan rate was reduced one-half percentage point in early January in lagged response to earlier declines in short-term rates. The drop apparently had been delayed as banks attempted to hold down loan growth as last year drew to a close, bolstering their capital positions in response to market concerns and the initial phase-in of risk-based capital requirements. The prime rate was reduced again after the cut in the discount rate in early February.

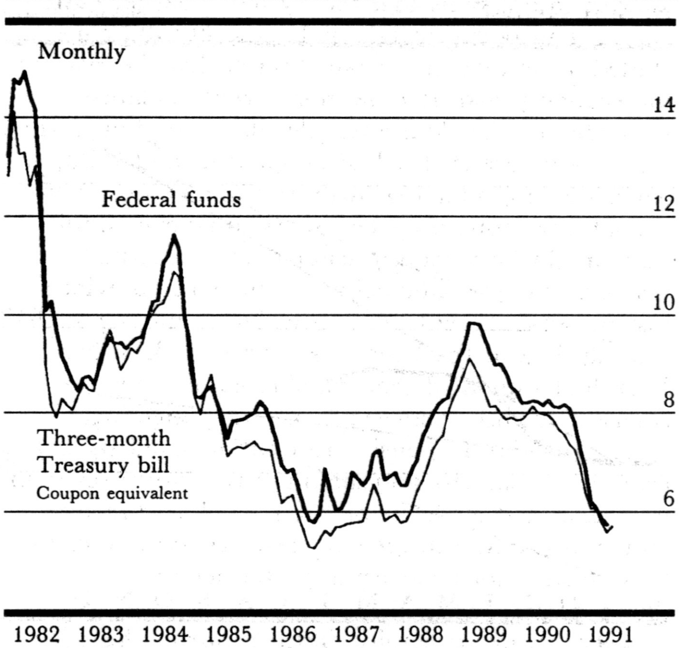
Longer-term rates also fell on balance over the first two months of the year, under the influence of monetary easings and prospects for lower inflation, especially when it became clear that the Gulf war would not interrupt oil supplies. Initial success in the Persian Gulf also led briefly to weakness in the dollar in foreign exchange markets, as safe-haven demands that had been boosting its value since late in 1990, in the face of a substantial easing of U.S. monetary policy, evaporated.

In March, however, long-term market rates began to firm on the rebound in consumer confidence and initial indications of a turnaround in the housing market, which were seen as pointing to a somewhat shorter and milder recession than many had previously feared. Rate increases were muted on private instruments, though, as risk premiums began to shrink in response to brightening prospects for a recovery. These gains extended even to below-investment-grade bonds, and growing optimism was reflected as well in a strong stock market in February and into March. The debt and equity instruments of banks generally outperformed broader indexes over this period, as the market apparently expected their earnings to be bolstered by lower short-term interest rates and the deterioration in the quality of their loan portfolios to be limited as the anticipated economic recovery materialized. Better prospects for a U.S. economic recovery about coincided with a turn toward more pessimism regarding the economic outlook abroad. As a result, the exchange value of the dollar reversed and began to appreciate sharply.

In the wake of the successful Gulf war and in view of initial signs that the System's earlier easing actions had begun to take hold, the FOMC concluded at its meeting in late March that the risks to the economy had become more evenly balanced. Accordingly, the Committee decided to end the formal tilt toward ease that it had adopted in mid-1990, when slowing money growth and tightening credit availability aroused concerns that financial conditions might be placing greater-than-anticipated restraint on economic acivity. Under the previous instructions, the FOMC's directive to the domestic trading desk at the Federal Reserve Bank of New York had stipulated that possible adjustments to reserve pressures between Committee meetings would be more responsive to unanticipated signs of economic weakness and abating price pressures than to unexpected evidence of strength. The directive issued at the March meeting restored symmetry to these instructions concerning intermeeting adjustments.

Interest rates generally declined during April, mainly at the short end, reflecting market participants' disappointment that the response they had expected to earlier monetary easings and to the rebound in consumer confidence had yet to show through in measures of economic activity. At the same time, with evidence also continuing to point to a further abatement of inflation, particularly as reflected in wage behavior, the Federal Reserve at the end of April reduced the discount rate another one-half percentage point, allowing about half that amount to show through to money market rates. As was the case in February, this action was followed by a one-half percentage point decline in the bank prime rate. Despite further monetary ease, the dollar continued to rally on foreign exchange markets, in part boosted by political developments abroad, particularly in the Soviet Union, and potential economic difficulties in Germany.

Short-term Interest Rates



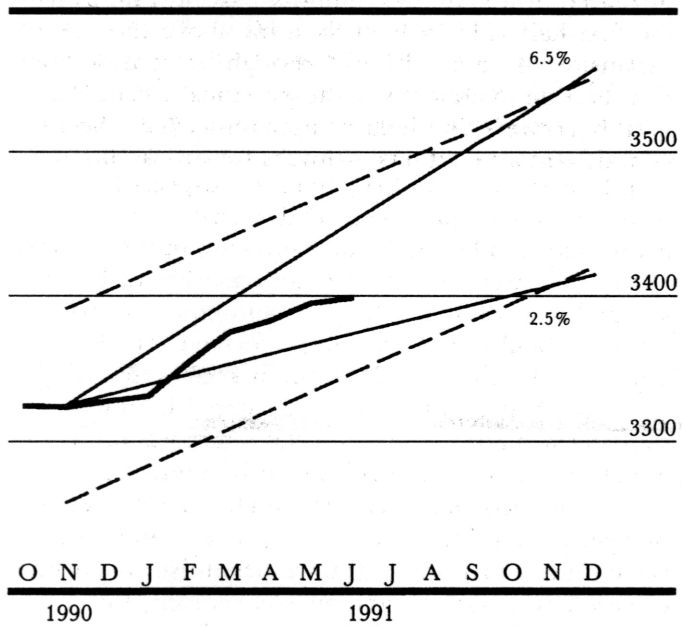
Last observation for June 1991.

Market interest rates were little changed until early June, when they rose in response to the release of data on employment and retail sales for May that strongly suggested the trough of the recession had been reached or at least was close at hand. The ensuing rise in interest rates was particularly sharp at the long end of the Treasury market. As signs of the recovery grew more distinct and interest rates firmed, the dollar strengthened further, and by June had retraced all of its declines of late 1990 and early 1991. On balance, Treasury bond yields rose almost one-quarter percentage point over the first half, while yields on investment-grade corporates were down close to one-half percentage point.

Monetary and Credit Flows

Despite the continuing weakness in economic activity, expansion of the monetary aggregates in the first half of 1991 picked up from the lackluster pace of late 1990, and M2 and M3 grew at annual rates of 3¾ and 2¼ percent, respectively, from the fourth quarter of last year through June. M2 growth increased as policy actions reduced short-term market interest rates relative to returns that could be earned on assets in this aggregate (a decline in the "opportunity cost" of holding M2). As a consequence, expansion of M2 exceeded the growth of nominal GNP. However, the growth in M2 (and decline in its velocity) was smaller than would have been expected on the basis of past relationships with income, interest rates, and opportunity costs. This shortfall of M2 growth from historical patterns followed an even greater discrepancy in 1990.

M2: Target Range and Actual Growth



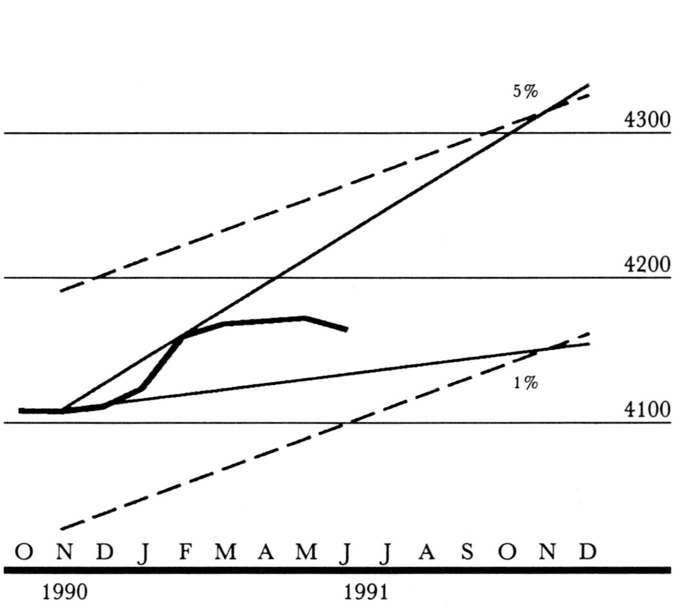
Growth of M3 over the first half was concentrated in the early months of the year, when it received a considerable boost from heavy issuance of large time deposits by U.S. branches and agencies of foreign banks. The strength of M3 in the first quarter also reflected strong growth of money market mutual funds. M3 was about flat between March and June. Shifts of foreign bank liabilities toward large time deposits slowed, large time deposits at domestic depositories ran off more rapidly with a contraction of their credit, and money funds decelerated as their yields came into line with market rates.

Bank credit expanded very slowly in the first half of 1991, and was concentrated in acquisitions of securities, particularly those of the Treasury and agencies. As in 1990, the recent strength in acquisitions of these securities owes in part to their favorable treatment under risk-based capital requirements. Mainly, however, it reflects the impact on loan growth of weaker spending by potential borrowers and continued lending restraint by banks.

Overall, the debt of domestic nonfinancial sectors increased at about a 4½ annual percent rate over the first half. This was likely a bit above the rate of expansion of nominal GNP, though by considerably less than on average over the previous decade, as both borrowers and lenders apparently have been adopting more cautious attitudes toward additional debt.

M3: Target Range and Actual Growth

Billions of Dollars



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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