February 19, 1992

1992 Monetary Policy Objectives

Summary Report of the Federal Reserve Board

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This Executive Summary provides highlights of the Board's Review to the Congress on the Full Employment and Balanced Growth Act of 1987.

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Testimony of Alan Greenspan Chairman, Federal Reserve Board

Mr. Chairman and members of the Committee, I am pleased to present the Federal Reserve's Monetary Policy Report to the Congress. The policy decisions discussed in the report were made against the backdrop of a troubled economy. The recovery that seemed to be in train at the time of our last report to Congress stalled, job losses have mounted, and confidence remains low.

Looking forward, though, there are reasons to believe that business activity should pick up. Indeed, anecdotal reports and early data seem to be indicating that spending is starting to firm in some sectors. A number of measures suggest that the balance sheets of many households and businesses have been strengthened, a development that should facilitate spending in the recovery. Similarly, banks and other lenders have taken steps to bolster their capital positions so that they will be able to supply the credit to support additional spending. And, most recently, broad measures of money have strengthened. Moreover, there are clear signals that core inflation rates are falling, implying the prospect that within the foreseeable future we will have attained the lowest rates of inflation in a generation, an encouraging indicator of future gains in standards of living for the American people. Still, the outlook remains particularly uncertain. This means that we at the Federal Reserve have to be particularly sensitive to signs that the anticipated strengthening in business activity is not emerging and be prepared to act should the need arise.

As background, I would like to discuss our recent economic performance, reviewing in some detail the causes of the disappointments we've experienced, and the important balance-sheet adjustments in process that promise eventually to support a resumption of sustainable economic growth.

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Macroeconomic Performance and Monetary Policy in 1991

Following the contraction of economic activity in the autumn of 1990 that resulted from the invasion of Kuwait and the subsequent sharp rise in oil prices, economic activity continued to decline in the first quarter of 1991. In response to the weakening of activity and anemic money growth, the Federal Reserve eased policy substantially over late 1990 and into early 1991.

By the spring, many signs pointed to economic recovery. The quick and successful conclusion of the Gulf war bolstered consumer confidence. Growth of the money stock was strengthening. Homebuilding had begun to stir, consumer spending had turned up, and industrial production was advancing. The lower interest rates and the retracing of the earlier jump in oil prices appeared to be providing support for an expansion of aggregate demand. In these circumstances, the odds appeared to favor a continued moderate recovery in jobs and employment during 1991.

Over the third quarter, however, evidence began to surface that the recovery had not taken hold. The impetus to consumer sentiment and spending that was provided by the completion of the Gulf war seemed to ebb, and consumer outlays turned down again. Businesses, apparently caught by surprise by this development, saw their inventories back up in the late summer and fall. With demand slackening, businesses engaged in another round of layoffs, and private nonfarm payrolls declined over the second half of 1991 while the civilian unemployment rate rose to 7.1 percent.

In addition, growth of the monetary aggregates slowed unexpectedly during the third quarter. Expansion of M2 virtually ceased, while M3 actually contracted—a nearly unprecedented occurrence. Judging from our surveys of banks, other contacts in the financial industry, and anecdotal information from borrowers, the supply of credit for many borrowers remained quite tight, particularly for those firms without access to open market sources of funds. Moreover, private credit demands weakened further.

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Against this background, and with signs that inflationary pressures were diminishing, the Federal Reserve took a number of steps to ease policy further in the second half of 1991. Through both open market operations and reductions in the discount rate, money market interest rates were lowered nearly two percentage points between August and December.

These monetary policy actions, building on those over the previous 2½ years, have resulted in a large cumulative reduction of interest rates. The federal funds rate has declined nearly 6 percentage points from its cyclical peak, and the discount rate by 3½ percentage points. Other short-term interest rates have fallen substantially as well. The prime rate also has been reduced appreciably, but by somewhat less than market rates as commercial banks have sought to bolster lending margins. In longer-term markets, bond and mortgage yields have dropped about 1¼ percentage points on balance from their cyclical highs, with much of the decline coming in the latter half of 1991. The decreases in interest rates appear to have given stock prices a boost as well, with most major indexes rising to record levels early this year.

Despite substantial decreases in interest rates in late 1990 and throughout 1991, however, M2 growth was only about 3 percent in 1991, the same as the sluggish pace of expansion of nominal GDP. M3 rose only 1¼ percent. Both aggregates ended the year only modestly above the lower bounds of their respective annual ranges. Growth of domestic nonfinancial sector debt, at 4¾ percent, also was near the lower bound of its monitoring range. Outside the federal sector, debt increased less than 3 percent for the year in reflection not only of depressed spending but also of a deleveraging in the household and business sectors and financial difficulties of many state and local governments.

The behavior of the monetary aggregates in 1991 relative to other economic variables was somewhat puzzling. Doubtless, part of the slow money growth was related to the weakness in borrowing and spending. But even after taking account of weak spending, growth of money was unusually slow. The velocity of M2 was about unchanged over the year rather than falling as would ordinarily be expected in circumstances of sharp declines in short-term market interest rates. It appears that certain interest rate relationships gave households incentives to limit their money holdings. Commercial banks,

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restraining their own balance sheets in response to weak loan demand and in an attempt to conserve capital, lowered deposit interest rates appreciably, especially late in the year. On the other hand, interest rates on consumer debt, particularly when adjusted for the lack of tax-deductibility, remained relatively high. As a result, many households apparently used deposit balances to pay off or to avoid taking on consumer credit. Also, the steep yield curve and the attractive returns recorded by bond mutual funds, as well as impressive gains in the stock market, apparently led many households to shift funds out of deposits and into capital market instruments, which are not included in the monetary aggregates.

Finally, a brisk pace of activity by the Resolution Trust Corporation appears to have depressed the monetary aggregates, especially M3. When the RTC takes savings and loan assets onto its own balance sheet, they are financed with Treasury securities, rather than depository liabilities. In effect, the RTC has taken on some of the role of thrift institutions, but its liabilities are not included in the monetary aggregates. In addition, the disruption of banking relationships as institutions are resolved, including the abrogation of some time deposit contracts, seems to lead investors to reassess their portfolio allocation and, in some cases, to shift funds out of deposits.

Thus, a number of factors reduced the public's demands for monetary balances in 1991. Some of these factors tended to raise the velocity of money, so that to an extent slow growth of M2 was not reflected in income flows. But the pattern of money and credit growth over the last half of the year appeared also to stem importantly from forces depressing spending and economic activity, which the Federal Reserve attempted to counter through easing money market conditions.

Balance Sheet Adjustments

Understanding these forces and the appropriate role for monetary policy under the circumstances requires stepping back several years. As I have discussed with you previously, the 1980s saw outsized accumulation of certain kinds of real assets and even more rapid growth of debt and leverage. To a degree, this buildup of balance sheets was a natural and economically efficient outcome of deregulation and financial innovation. It also may have reflected a lingering inflation psychology from the 1970s—that is, people may have expected a rapid increase in the general price level, and especially in the prices of specific real assets, such as real estate properties, that would make debt-financed purchases profitable.

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But in retrospect, the growth of debt and leverage was out of line with subsequent economic expansion and asset price appreciation. Indeed, the burden of debt relative to income mounted as asset values, especially for real property, declined or stagnated. In part, our current economic adjustments can be seen as arising out of a process in which debt is being realigned with a more realistic outlook for incomes and asset values.

Rapid rates of debt-financed asset accumulation were broad-based during the 1980s. For example, households purchased cars and other consumer goods at a brisk pace. Although household income was increasing swiftly in this period, the growth of expenditures was faster. Household saving rates dropped from about 8 percent at the beginning of the decade to a 4 to 5 percent range by its end. This was reflected in part in burgeoning consumer installment credit, which expanded at an average annual rate of 15 percent between 1983 and 1986. In addition, mortgage debt expanded at an 11 percent pace between 1983 and 1989. Most of this increase was against existing homes, representing borrowing against rising values either in the process of home turnover or as owners borrowed against higher equity. Mortgage borrowing also financed a substantial amount of buying of new homes, which in some parts of the country at times seemed to be motivated more by speculative considerations than by fundamental needs.

The 1980s also witnessed a dramatic increase in desired leverage of the business sector, which fostered a wave of mergers and buyouts. These transactions typically involved substantial retirements of equity financed through issuance of debt; equity retirements in the nonfinancial corporate sector exceeded new equity issuance by a staggering $640 billion in the 1984–1990 period. Such restructurings often were based, at least in part, on a well-founded quest for increased efficiency, and gains were achieved by a number of firms. However, many of these deals also were predicated on overly optimistic assumptions about what the economy could deliver—that rapid economic growth could continue without setback and that asset prices would always rise.

A primary example of the accumulation of debt and real assets occurred in commercial real estate markets. In the early 1980s, when space was in unusually short supply, commercial real estate received an additional push from the Economic Recovery Tax Act, which provided an acceleration of depreciation allowances for capital goods. While an adjustment was appropriate and overdue, that for commercial structures was excessive, resulting in tax lives that were far shorter than economic fundamentals would dictate. This shift in incentives led to a surge in debt-financed commercial construction during the 1980s.

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Financial institutions, of course, participated in this process by lending heavily; indeed, their aggressive lending behavior probably contributed to the speed of debt accumulation. During the economic expansion, bank credit expanded at an average annual rate of nearly 9 percent, well in excess of the growth of nominal income. Banks lent heavily against real estate collateral, for corporate restructurings, and for consumer credit, and, in addition, for more traditional business purposes. Life insurance companies also expanded their portfolios rapidly, with growth in real estate loans especially prominent.

By the end of the 1980s, the inevitable correction was upon us. The economy was operating close to capacity, so that growth had to slow to a pace more in line with its long-run potential. Inflation did not pick up much, contrary to what some might have expected as capacity was approached. In the commercial real estate sector, soaring vacancy rates and a change in tax law in 1986 brought the boom to an end, producing sharp decreases in prices of office buildings in particular.

Together, these developments resulted in declines in the value of assets and growing problems in servicing the associated debt out of current income. Because of the runup in leverage over previous years, these problems have been more severe than might be expected just from the slowing in income and spending. And the difficulties of both borrowers and lenders have fed back on spending, exacerbating the economic downturn during the Gulf crisis, and inhibiting the recovery.

Faced with mounting financial problems and uncertainty about the future, people's natural reaction is to withdraw from commitments where possible and to conserve and even build savings and capital. Both households and businesses, concerned about their economic prospects, over the past two years or so have taken a number of measures to reduce drains on their cash flow and to lower their exposure to further surprises. Part of this process has involved unusually conservative spending patterns and part has involved the early stages of a restructuring of financial positions.

Businesses, for example, have strived to reduce fixed costs. To do this, they have cut back staffing levels and closed plants. They have tried to decrease production promptly to keep inventories in line. Firms also have taken steps to lower their risk exposures by restructuring their sources of funds to reduce leverage, enhance liquidity, and cut down on interest obligations.

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The response of households has been analogous. To increase their net worth, households have taken steps to increase their savings by restraining expenditures. To reduce interest expenses, they have paid down consumer debt, and as long-term interest rates have declined, they have refinanced mortgages and other debt at lower interest rates.

Lenders too have drawn back. With capital impaired by actual and prospective losses on loans, especially on commercial real estate, banks and other intermediaries have not only adopted much more cautious lending standards, but also have attempted to hold down asset growth and bolster capital. They have done so in part by aggressively reducing what they pay for funds, by more than they have reduced what they charge for credit. Like other businesses, they have taken steps to pare expenses generally, including reducing work forces and looking for cost-saving consolidations with other institutions. To a considerable extent, this response has been rational and positive for the long-term health of our financial intermediaries. But in many cases it seems to have gone too far, impelled to an extent by the reaction of supervisors to the deteriorating situation.

The Federal Reserve has taken a number of measures to facilitate balance sheet restructuring and adequate flows of credit. Together with other supervisors, we have directed examiners to consider not only the current market value of collateral against performing loans, but the overall quality of the credits. We also have met on numerous occasions with bankers as well as bank examiners to clarify bank supervisory policies and to emphasize the importance of banks continuing to lend and take reasonable risks.

Monetary policy also has in part been directed in recent quarters to supporting balance sheet restructuring that is laying the groundwork for renewed, sustained, economic expansion. We recently reduced reserve requirements on transactions deposits. This will free up some funds for lending or investment and should over time enhance the ability of banks and their customers to build capital.

In addition, lower short-term interest rates clearly have been helpful to debtors, but their contribution to the restructuring process would be relatively muted if long-term rates had not also declined at the same time and stock prices were not buoyant. Reductions in short-term rates that were expected very soon to be reversed or that were not seen as consistent with containing inflation would contribute little to the strengthening of balance sheets fundamental to enhancing our long-term economic prospects.

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In part because we have seen declines in long- as well as short-term rates and increases in equity prices, progress has been made in balance sheet restructuring, and hopefully more is in train. As a result of lower interest rates, household debt service as a percent of disposable personal income has fallen in the past year, from about 19½ to about 18½ percent. Moreover, further declines are in prospect as more refinancing occurs and as interest costs on floating-rate debt, such as adjustable-rate mortgages, gradually reflect current interest rates.

In the business sector, similar patterns can be observed. With corporate bond rates close to their lowest levels in more than a decade, a large number of firms in recent months have called, retired, and replaced a considerable volume of high-cost debt. A flood of issuance of longer-term debt and equity shares has reduced dependence of firms on short-term obligations. A number of the equity deals constituted so-called "reverse LBOs"—the deleveraging of highly leveraged and therefore rather risky firms. The ratio of corporate debt to equity in book value terms has only begun to edge down, but the increase in equity, together with the lower level of interest rates, has enabled many corporations to make significant headway in lowering interest expenses over the past two years, and further decreases in corporate debt burdens are presumably in prospect. Restraint on inventories and other spending has contributed to this result by keeping outlays in close alignment with internally generated funds. And the strengthening of balance sheets is paying off in terms of credit evaluations. Downgrades of nonfinancial firms, though still greater than upgrades, are well below the levels of last winter and spring, and upgrades have risen slightly.

The condition of our financial institutions also is improving. In the banking sector, wider interest margins seemed to be boosting profits by the end of last year. In addition, many institutions have taken difficult but necessary measures to control noninterest expenses. Reflecting an improved earnings outlook and a generally favorable equity market, the stock prices of large banks have doubled on average from their 1990 lows, and the premium paid by many money-center banks on uninsured debentures has dropped several percentage points. Increased share prices have spurred a number of holding companies to sell substantial volumes of new equity shares in the market, contributing to a significant rise of capital ratios in the banking system, despite still-large provisions for loan losses. Measures of bank liquidity, such as the ratio of securities to loans in bank portfolios, have risen appreciably, signalling an improved ability of banks to lend.

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The balance-sheet adjustments that are in progress in the financial and nonfinancial sectors alike are without parallel in the post-war period. Partly for that reason, assessing how far the process has come and how far it has to go is extraordinarily difficult. As increasingly comfortable financial structures are built, though, the restraint arising from this source eventually should begin to diminish. In any case, the nature and speed of balance sheet restructuring are important elements that we will need to continue to monitor on a day-by-day basis in assessing whether further adjustments to the stance of monetary policy are appropriate.

Economic Expansion and Money and Credit Growth in 1992

Against this background of significant progress in balance-sheet strengthening as well as lower real interest rates, the Board members and Reserve Bank Presidents expect a moderate upturn in economic activity during 1992, although in the current context the outlook remains particularly uncertain. According to the central tendency of these views, real output should grow between 1¾ and 2½ percent this year. The unemployment rate is projected to begin declining, finishing the year in the vicinity of 6¾ to 7 percent.

An especially favorable aspect of the outlook is that for inflation. The central tendency of the Board members' and Reserve Bank Presidents' forecast is that inflation, as measured by the Consumer Price Index, will be in the neighborhood of 3 to 3½ percent over the four quarters of 1992, compared with a 3 percent rise in 1991. However, the CPI was held down last year by a retracing of the sharp runup in oil prices that resulted from the Gulf crisis. Consequently, our outlook anticipates a significant improvement in the so-called core rate of inflation. With appropriate economic policies, the prospects are good for further declines in 1993 and beyond even as the economy expands.

To support these favorable outcomes for economic activity and inflation, the Committee reaffirmed the ranges for M2, M3, and debt that it had selected on a tentative basis last July—that is, 2½ to 6½ percent for M2, 1 to 5 percent for M3, and 4½ to 8½ percent for debt, measured on a fourth-quarter-to-fourth-quarter basis. These are the same as the ranges used for 1991. The 1992 ranges were chosen against the backdrop of anomalous monetary behavior during the last two years. Since 1989, M2 has posted widening shortfalls from the levels historical experience indicates would have been compatible with actual nominal GDP and short-term market interest rates.

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The appropriate pace of M2 growth within its range during 1992 thus will depend on the intensity with which forces other than nominal GDP turn out to affect money demand. Depository institutions are likely to continue reducing their rates on retail deposits in lagged response to the steep declines in money market yields before year-end. Those deposit-rate reductions could be significant, especially if banks are not seeking retail deposits, given their continued caution in extending credit and borrowers' continued preference for longer-term sources of credit to strengthen balance sheets. With the effects of lower deposit rates contributing to further shifts of funds into longer-term mutual funds and into debt repayment, and with the RTC remaining active in resolving troubled thrifts, the velocity of M2 could increase this year, independently of changes in market interest rates.

The ongoing restructuring of depository institutions, as in the last two years, is likely to continue to have an even larger influence on M3 than on M2 growth. Assets previously on the books of thrifts that are acquired by the RTC will be financed by Treasury debt rather than the liabilities of thrifts. Managed liabilities in M3 should continue to be more depressed by resolution activity than retail CDs. The reaffirmed range for M3 growth thus remains lower than for M2.

Nonfinancial debt growth is likely to be a little faster than last year's 4¾ percent increase. The wider federal deficit in prospect for 1992 will increase Treasury borrowing. Assuming output and incomes are again expanding, balance sheets in somewhat better condition, and credit conditions no longer tightening, the borrowing of households and businesses may pick up a little, although their overall posture probably will remain cautious.

Will these ranges for money and credit growth prove to be appropriate? Obviously, we believe that the answer is yes. But I should reemphasize the sizable uncertainties that prevail. The ongoing process of balance sheet restructuring may affect spending, as well as the relationship of various measures of money and credit to spending, in ways we are not anticipating. In assessing monetary growth in 1992, the Federal Reserve will have to continue to be sensitive to evolving velocity patterns.

Concluding Comments

Our focus, quite naturally and appropriately, has been on our immediate situation—the causes of the recent slowdown and the prospects for returning to solid growth this year. However, as we move forward, we cannot lose sight of the crucial importance of the longer-run performance of the economy.

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As I have noted before, much of the difficulty and dissatisfaction with our economy comes from a sense that it is not delivering the kind of long-term improvement in living standards we have come to expect. The contribution monetary policy can make to addressing this deficiency is to provide a financial background that fosters saving and investment and sound balance sheet structures. Removing over time the costs and uncertainties associated with ongoing inflation encourages productivity-enhancing investment. Moreover, inflation tends to promote leverage and over-accumulation of real assets as a hedge against increases in price levels; progress toward price stability provides a backdrop for borrowing and lending decisions that lead to strong balance sheets, far less apt to magnify economic disturbances.

A crucial aspect of our recent economic performance is the difficult situation of our financial sector. Clearly, some of the weakness of the economy over the past two years arose from the restraint on the supply of credit—the so-called credit crunch. Both depository institutions and other financial intermediaries made some of the same mistakes of judgment about the likely appreciation of asset prices as did borrowers. In addition, though, the balance sheets of many financial intermediaries themselves were not robust; many lacked adequate capital to continue to lend to good credit risks in the face of losses from their previous lending mistakes. Our emphasis on improving the capitalization of depository institutions over time, where we have already made substantial progress, should help bolster their ability to lend both in good times and bad. We could make further strides in strengthening our depository institutions through removal of outmoded constraints on their behavior. By loosening strictures on the ability of these firms to compete across arbitrary boundaries of product line and geography, we would improve their profitability and capital. Their strengthened position should augment their ability to lend and potentially could reduce demands on the federal safety net.

Finally, we should consider carefully the effects of the extremely low rates of national saving that we have experienced for a decade. Certainly, low personal and corporate saving rates have contributed to the deterioration in balance sheets that has impaired our economic performance in recent years. The large stocks of federal debt that have been built up, too, likely have adversely affected our economic prospects by putting upward pressure on real interest rates and thus stunting the growth of the capital stock, on which our future incomes depend.

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In considering the various fiscal options that are before you as members of the Congress, I urge you to keep in mind their long-term implications for national saving. Through a combination of fiscal policies directed at reducing budget deficits and boosting private saving and monetary policies aimed at noninflationary growth, we can achieve the strong economic performance that our fellow citizens rightly expect.

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Monetary Policy and the Economic Outlook for 1992

Monetary Objectives for 1992

In formulating its objectives for monetary policy for 1992, the Federal Open Market Committee has sought to promote a sustainable upturn in economic activity while continuing to build upon the hard-won gains against inflation that have already been made. The task of translating these objectives into specific ranges for money and debt continues to be complicated by the ongoing restructurings of depositories and by the evolving attitudes towards credit on the part of borrowers and lenders. The Committee believes that the rechanneling of credit flows away from depository institutions could well continue to produce slower growth in the broad monetary aggregates than normally would be associated with a given path for nominal GDP.

Ranges of Growth of Monetary and Credit Aggregates[1]
(Percentage change, fourth quarter to fourth quarter)

	1990	1991	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

Taking account of these effects, the Committee has deemed the ranges for 1992 tentatively adopted last July as appropriate for achieving its objectives. The M2 range for 1992 is 2½ to 6½ percent, unchanged from 1991. Demands for M2 relative to income would be damped if, as seems likely, banks and thrifts continue to reduce deposit rates in lagged response to the decline that has occurred in market rates. These deposit-rate reductions could be especially large if credit continues to be channeled outside depositories, and in this case, relatively modest growth in M2 would be adequate to support a satisfactory outcome for the economy. On the other hand, as the balance sheets and capital positions of depositories continue to improve, banks and thrifts may adopt a generally more accommodative posture with respect to credit extensions and would therefore have greater need for retail deposits. In that event, somewhat faster growth of M2 would be appropriate.

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On balance, the Committee's M2 range for 1992 allows room for a variety of developments in the intermediation process and thus in the behavior of monetary velocity. Flexibility in interpreting M2 within its range is particularly important at this time, in light of the ongoing and unpredictable shifts in the patterns of credit usage and financial intermediation that likely will continue to buffet our financial system. Looking ahead to future years, the Committee also recognizes that the range for M2 growth may eventually have to be lowered in order to put in place the monetary and credit conditions consistent with price level stability.

The target range for M3 for 1992 remains at 1 to 5 percent. Although credit growth is expected to pick up somewhat in 1992, in line with a firming of economic activity, much of this credit likely will be financed outside the depository system. The thrift industry is expected to contract further as activity by the Resolution Trust Corporation continues apace, and banks, faced with continued—though moderating—pressures on capital positions, will still be somewhat hesitant to expand. At the same time, additional households are likely to refinance adjustable-rate mortgages with fixed-rate obligations that can easily be securitized, and corporations will probably continue to turn to equity markets and long-term bonds rather than bank loans. As a result, depository funding needs are likely to remain damped relative to the pace of economic activity, and the velocity of M3 should consequently rise further.

The monitoring range for the aggregate debt of domestic nonfinancial sectors for 1992 is 4½ to 8½ percent, also unchanged from 1991. Federal government borrowing is expected to remain heavy in 1992, given the large budget deficit. Debt growth of nonfederal sectors, however, should remain fairly subdued relative to economic activity, as borrowers and lenders alike maintain a cautious approach to leverage, stemming in part from a desire to make further repairs to damaged balance sheets.

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Economic Projections for 1992

Although the long-standing structural problems that aborted the fledgling recovery last summer clearly are being addressed, the speed of their resolution—and the associated restraint on economic growth—is quite difficult to gauge, augmenting the usual uncertainties in assessing the economic outlook. On the whole, however, the members of the Board of Governors and the Reserve Bank Presidents believe that, with the easing of monetary conditions to date providing considerable impetus to the economy, the most likely outcome is for a moderate reacceleration of activity over 1992. At the same time, they anticipate that the trend toward price stability, which now appears to be rooted more securely, will be sustained through this year.

The forecasts of most of the governors and presidents for growth of real gross domestic product are in a range of 1¾ to 2½ percent measured from the fourth quarter of 1991 to the fourth quarter of 1992. With employers likely to be cautious about hiring until they are fully persuaded of the sustained vitality of the upturn, gains in employment are expected to come slowly. Thus, only a small improvement in the unemployment rate is anticipated this year, with the central tendency of projections being

Economic Projections for 1992

Measure		1991 Actual	FOMC Members and other FRB Presidents		Administration
			Range	Central Tendency	
Percentage change, fourth quarter to fourth quarter:[1]	Nominal GDP	3.2	4 to 6	4½ to 5¾	5.4
	Real GDP	.2	1½ to 2¾	1¾ to 2½	2.2
	Consumer Price Index	2.9	2½ to 3½	3 to 3½	3.1
Average level in the fourth quarter, percent:[3]	Unemployment rate[2]	6.9	6¾ to 7¼	6¾ to 7	6.8

1. Actual for the fourth quarter of the preceding year to the fourth quarter of the year indicated.

2. All urban consumers.

3. Percentage of the civilian labor force.

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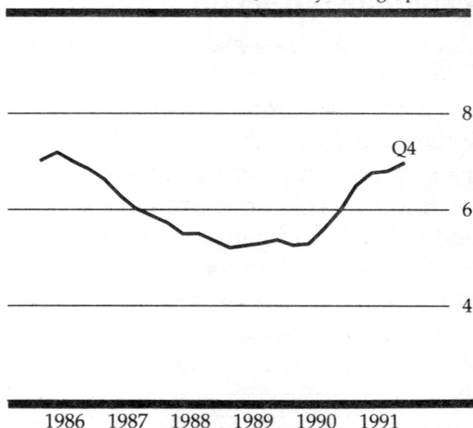
a range of 6¾ to 7 percent for the fourth quarter of 1992. With regard to inflation, the central tendency range for the CPI increase this year is 3 to 3½ percent. These forecasts are, in general, very similar to the projections presented by the Administration in the fiscal year 1993 budget. Indeed, the Administration's forecast for nominal GDP is well within the Committee's central tendency range and thus appears to be quite consistent with the FOMC's monetary ranges.

In their discussion earlier this month of the economic outlook, the Board members and Reserve Bank presidents observed that the effects of recent job losses and weak consumer confidence are likely to restrain activity in the near term. Under the circumstances, the Board members and Bank presidents stressed that economic developments need to be monitored closely to guard against the possibility that the economy might falter. Nonetheless, the monetary stimulus already in train is expected to provide effective support for economic growth this year, and in this regard the early indications of a marked pickup in residential real estate activity and a rise in retail sales are a particularly favorable sign.

Civilian Unemployment Rate



It is also expected that the drags on growth from credit supply disruptions and from the restructuring of household and business balance sheets will begin to lessen over the year. As noted above, this is obviously an area of substantial uncertainty. However, as household and corporate debt loads diminish in an environment of stronger economic activity, and as lower interest rates continue to ease financing burdens of borrowers, consumers and businesses should be poised to participate more fully in the economic expansion. Moreover, the problems of credit availability that have plagued the economy over the past couple of years should begin to ease in 1992 as the economic recovery takes hold and lenders become more confident about extending credit.

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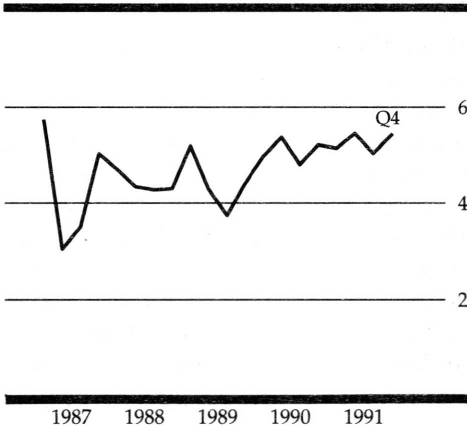
Personal Saving

Percent of disposable income, quarterly average

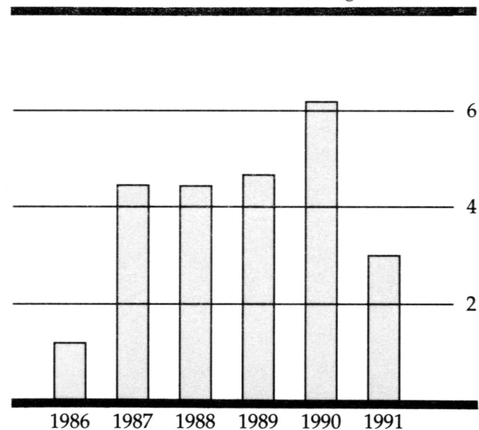


Nonetheless, the pace of expansion this year is expected to remain weaker than in previous business cycle recoveries. In large part, this expectation reflects some still unresolved economic and financial imbalances in particular segments of the economy. The persistent overhang of space in office and other commercial buildings undoubtedly will inhibit new construction in that sector for some time. In addition, the budgetary constraints that have capped government spending are likely to linger; a good many states and localities are finding that budget gaps are reopening, despite the spending cuts and tax increases they instituted last year. Meanwhile, the external sector is expected to have a relatively neutral net influence on domestic production this year; foreign demand—particularly from Mexico and developing countries in Asia—should continue to boost export growth, but the anticipated pickup in domestic purchases is likely to draw in additional imports as well, limiting the potential for further substantial improvement in the trade balance.

Only a minority of Board members and Reserve Bank Presidents foresee a smaller increase this year in the overall CPI than the 3 percent rise experienced in 1991. But the pickup in inflation suggested by the 3 to 3½ percent central-tendency range is deceptive: the underlying trends of price movement are more favorable.

Consumer Prices*

Percent change, Dec. to Dec.



*Consumer price index for all urban consumers.

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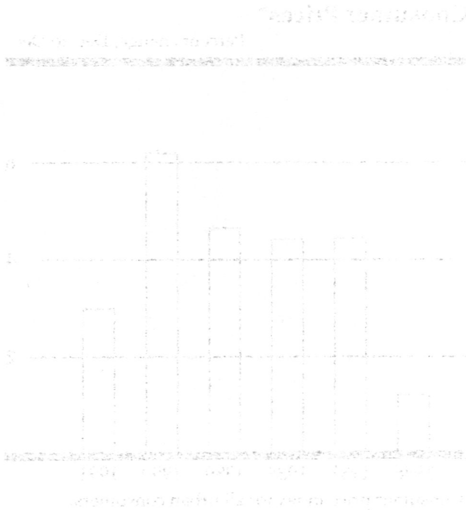
The CPI was held down to a substantial degree last year by the unwinding of the energy price shock that followed Iraq's invasion of Kuwait in August 1990, and further sharp declines in energy prices do not appear likely in the current environment. However, an ongoing deceleration in prices is evident for a wide range of other goods and services, and with inflationary tendencies under considerable restraint from several factors—including further moderation in labor cost growth, continued slack in industrial product markets, and small increases in import prices—"core" inflation is expected to move down appreciably in 1992. Indeed, this trend should carry into 1993—a pattern that bodes well for the achievement of a balanced, sustained economic expansion.



Monetary and Financial Developments in 1991

When the Federal Reserve presented its midyear monetary policy report to Congress last July, a moderate economic upturn was under way. Consumer spending and housing activity had risen considerably since the winter, bolstered by the decline in oil prices, by a rebound in consumer confidence in the wake of the allied victory in the Persian Gulf conflict, and by lower interest rates. Inventories had been trimmed appreciably, orders were rising, and businesses, while still cautious, had begun to increase employment and production. The key monetary aggregates had accelerated and were around the middle of their 1991 target ranges. With the stance of monetary policy seemingly conducive to an upturn in economic activity, the Federal Reserve, after having progressively reduced pressures on reserve positions earlier in the year, maintained a more neutral money market posture in the spring and early summer.

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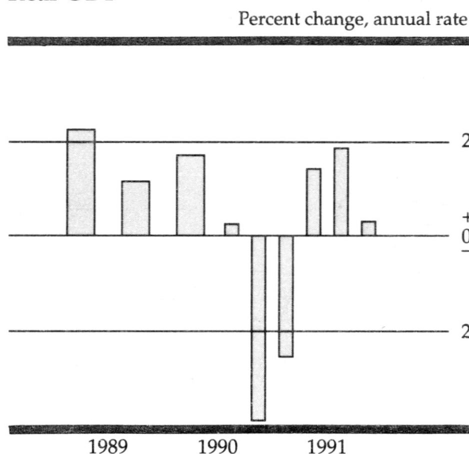

As the year wore on, however, the incipient recovery lost its momentum. Consumer spending turned down, and business and consumer sentiment began to erode. Inventories at wholesale and retail trade establishments began to increase relative to sales, inducing a new outbreak of production adjustments and lay-offs that continued through year-end. Although the economy—as measured by its real gross domestic product—continued to grow in the second half of the year, the pace of expansion was only marginally positive.

The faltering of the recovery process apparently owed to a variety of forces, some of which were operating well before the oil price shock of 1990 tipped the economy into recession. In a sluggish economy and amid unexpectedly weak asset values—particularly in real estate—deteriorating financial positions of debt-laden households and corporations further damped credit demands and aggregate spending. Financial intermediaries, chastened by their negative experience with earlier loans, became more hesitant about extending new credit; the resultant tighter lending standards deepened the slowdown in economic activity and inhibited the subsequent recovery. In the government sector, where deficits remained large, not only at the federal level, but also in many state and local jurisdictions, efforts to curb spending and increase revenues constituted a further drag on aggregate demand in the short run.

Inflation, meanwhile, moved down over the second half of 1991. Weak demand reduced pressures in both labor and product markets, and, after some acceleration of wages and prices in 1989 and 1990, an underlying disinflationary trend has now been established. Important in this process has been a reduction in inflation expectations, visible not only in a variety of survey data but also in the behavior of securities markets.

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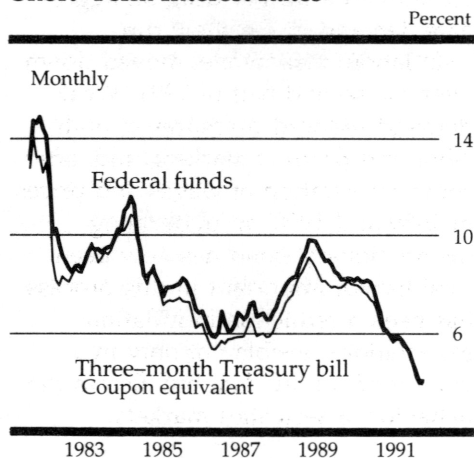
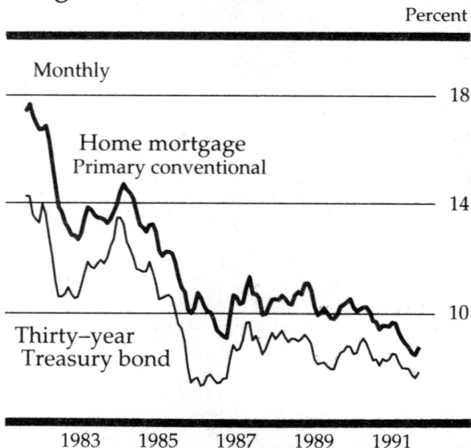
With actual and prospective inflationary pressures easing, economic activity flagging, and the broader monetary aggregates weakening and growing near the bottom of their target ranges, the Federal Reserve resumed easing money market conditions in the second half of the year. As a result, the federal funds rate fell from 5¾ percent in July to 4 percent by year-end, and most other short-term rates followed suit; the discount rate was also reduced over this period, from 5½ percent to 3½ percent, the lowest rate in nearly 30 years. Long-term interest rates, which had failed to respond to declines in money market rates in the early months of the year, came down significantly in the latter part of 1991, partly in response to the easing in inflationary expectations.

Short–Term Interest Rates



Last observation is for the first two weeks of February 1992.

Long–Term Interest Rates



Last observation is for the first two weeks of February 1992.

Although long-term rates have backed up some in recent weeks, they remain appreciably below the levels of last summer. The decline in rates has helped reduce the financial burdens of highly-leveraged households and corporations, who have taken this opportunity to refinance mortgages and to replace existing debt with new lower-cost bonds. Lower interest rates also have contributed to an increase in stock prices, inducing firms to boost equity issuance and to pay down debt, further strengthening their balance sheets. With the decline in U.S. interest rates, the foreign exchange value of the dollar has largely reversed the upward movement that had occurred earlier in the year.

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Foreign Exchange Value of the U.S. Dollar*

*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 unusually slow growth of the key monetary and credit aggregates last year was, to a degree, indicative of the continuing restraint on private credit usage and spending. The aggregate debt of domestic nonfinancial sectors—abstracting from federal government debt, which continued to grow briskly—expanded only 2¾ percent in 1991, the slowest advance in decades, and below the pace of nominal GDP; households, nonfinancial businesses, and state and local governments all retrenched, curbing spending and borrowing in order to buttress deteriorating financial positions.

The weakness in the monetary aggregates M2 and M3 reflected not only subdued overall credit usage but also a continued decline in the share of credit intermediated by depositories. With the thrift industry contracting further, commercial banks exercising caution in their credit extensions, and borrowing demand concentrated in longer-term instruments, depository credit continued to shrink as a share of overall credit extensions. As a result, the velocity of M3—a monetary aggregate that comprises most of the liabilities used by depositories to fund credit growth—increased again in 1991, as M3 grew only 1¼ percent, near the bottom of its target range. Depository restructuring also restrained M2, which grew in line with nominal GDP despite a steep drop in short-term market interest rates, which ordinarily would have been expected to depress the velocity of this aggregate. Banks, eager to improve capital positions, reduced deposit rates more than loan rates, increasing the incentive for households to pay down debt rather than to accumulate monetary assets. Less aggressive pursuit of retail accounts by depositories also led investors to switch into other financial

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assets, such as bond and stock mutual funds. Flows into these funds helped finance credit that had formerly been intermediated by depositories, facilitating shifts to longer-term borrowing and reducing the adverse effects of any retrenchment by banks and thrifts on the cost and availability of credit to many borrowers. However, some types of lending that are not so easily rechanneled—such as construction loans and credits to small and lower-rated businesses—have been curtailed, and a number of borrowers now face more stringent credit terms.

Growth of Money and Debt (Percentage change)

		M1	M2	M3	Debt of Domestic Nonfinancial Sectors
Fourth quarter to fourth quarter	1980	7.5	8.9	9.5	9.2
	1981	5.4 (2.5)*	9.3	12.3	9.9
	1982	8.8	9.1	9.9	9.2
	1983	10.4	12.2	9.9	11.3
	1984	5.4	8.0	10.8	14.1
	1985	12.0	8.7	7.6	13.8
	1986	15.5	9.2	9.0	13.8
	1987	6.3	4.3	5.9	10.4
	1988	4.3	5.2	6.4	9.4
	1989	0.6	4.8	3.6	8.2
	1990	4.2	3.8	1.7	6.9
	1991	8.0	3.1	1.3	4.7
Quarterly growth rates 1991 *(annual rate)*	Q1	5.2	3.5	3.3	4.5
	Q2	7.4	4.3	1.8	4.0
	Q3	7.5	1.1	–1.1	4.9
	Q4	11.1	3.3	1.2	5.2

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

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