July 20, 1993

1993 MONETARY POLICY OBJECTIVES

Midyear Review of the Federal Reserve Board

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

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Testimony of Alan Greenspan
Chairman, Federal Reserve Board

Thank you for this opportunity to discuss the Federal Reserve's semiannual monetary policy report to the Congress. My remarks this morning will cover the current monetary policy and economic settings, as well as the Federal Reserve's longer-term strategy for contributing, to the best of our abilities, to the nation's economic well-being.

As the economic expansion has progressed somewhat fitfully, our earlier characterization of the economy as facing stiff head winds has appeared increasingly appropriate. Doubtless the major head wind in this regard has been the combined efforts of households, businesses, and financial institutions to repair and to rebuild their balance sheets following the damage inflicted in recent years as weakening asset values exposed excessive debt burdens.

But there have been other head winds as well. The build-down of national defense has cast a shadow over particular industries and regions of the country. Spending on nonresidential real estate dropped dramatically in the face of overbuilding and high vacancy rates and has remained in the doldrums. At the same time, corporations across a wide range of industries have been making efforts to pare employment and expenses in order to improve productivity and their competitive positions. These efforts have been prompted in part by innovative technologies, which have been applied to almost every area of economic endeavor, and have boosted investment. However, their effect on jobs and wages through much of the expansion also has made households more cautious spenders.

In the past several years, as these influences have restrained the economy, they have been balanced in part by the accommodative stance of monetary policy and, more recently, by declines in longer-term interest rates as the prospects for credible federal deficit cuts improved. From the time monetary policy began to move toward ease in 1989 to now, short-term interest rates have dropped by more than two-thirds and long-term rates have declined substantially, too. All along the maturity spectrum, interest rates have come down to their lowest levels in twenty or thirty years, aiding the repair of balance sheets, bolstering the cash flow of borrowers, and providing support for interest-sensitive spending.

The process of easing monetary policy, however, had to be closely controlled and generally gradual, because of the constraint imposed by the marketplace's acute sensitivity to inflation. As I pointed out in my February testimony to the Congress, this is a constraint that did not exist in an earlier time. Before the late 1970s, financial market participants and others apparently believed that, while inflationary pressures might surface from time to time, the institutional structure of the U.S. economy simply would not permit sustained inflation. But as inflation and, consequently, long-term interest rates soared into the double digits at the end of the 1970s, investors became painfully aware that they had underestimated the economy's potential for inflation. As a result, monetary policy in recent years has had to remain alert to the possibility that an ill-timed easing could be undone by a flare-up of inflation expectations, pushing long-term interest rates higher, and short-circuiting essential balance sheet repair.

The cumulative monetary easing over the last four years has been very substantial. Since last September, however, no further steps have been taken, as the stance of policy has appeared broadly appropriate to the evolving economic circumstances.

That stance has been quite accommodative, especially judging by the level of real short-term interest rates in the context of, on average, moderate economic growth. Short-term real interest rates have been in the neighborhood of zero over the last three quarters. In maintaining this accommodative stance, we have been persuaded by the evidence of persistent slack in labor and product markets, increasing international competitiveness, and the decided absence of excessive credit and money expansion. The forces that engendered past inflationary episodes appear to have been lacking to date.

Yet some of the readings on inflation earlier this year were disturbing. It appeared that prices might be accelerating despite product market slack and an unemployment rate noticeably above estimates of the so-called "natural" rate of unemployment—that is, the rate at which price pressures remain roughly constant.

In the past, the existing degree of slack in the economy had been consistent with continuing disinflation.

However, the inflation outcome, history tells us, depends not only on the amount of slack remaining in labor and product markets, but on other factors as well, including the rate at which that slack is changing. If the economy is growing rapidly, inflation pressures can arise, even in the face of excess capacity, as temporary bottlenecks emerge and as workers and producers raise wages and prices in anticipation of continued strengthening in demand. Near the end of last year, about the time many firms probably were finalizing their plans for 1993, sales and capacity utilization were moving up markedly and there was a surge of optimism about future economic activity. This may well have set in motion a wave of price increases, which showed through to broad measures of prices earlier this year.

Moreover, inflation expectations, at least by some measures, appear to have tilted upward this year, possibly contributing to price pressures. The University of Michigan survey of consumer attitudes, for example, reported an increase in the inflation rate expected to prevail over the next 12 months from about 3¾ percent in the fourth quarter of last year to nearly 4½ percent in the second quarter. Preliminary data imply some easing of such expectations earlier this month, but the sample from which those data are derived is too small to be persuasive. Moreover, the price of gold, which can be broadly reflective of inflationary expectations, has risen sharply in recent months. And at times this spring, bond yields spiked higher when incoming news about inflation was most discouraging.

The role of expectations in the inflation process is crucial. Even expectations not validated by economic fundamentals can themselves add appreciably to wage and price pressures for a considerable period, potentially derailing the economy from its growth track.

Why, for example, despite an above-normal rate of unemployment and permanent layoffs, have uncertainties about job security not led to further moderation in wage increases? The answer appears to lie at least in part in the deep-seated anticipations understandably harbored by workers that inflation is likely to reaccelerate in the near term and undercut their real wages.

The Federal Open Market Committee (FOMC) became concerned that inflation expectations and price pressures, unless contained, could raise long-term interest rates and stall economic expansion. Consequently, at its meeting in May, while affirming the more accommodative policy stance in place since last September, the FOMC also deemed it appropriate to initiate a so-called asymmetric directive. Such a directive, with its bias in the direction of a possible firming of policy over the intermeeting period, does not prejudge that action will be taken—and indeed none occurred. But it did indicate that further signs of a potential deterioration of the inflation outlook would merit serious consideration of whether short-term rates needed to be raised slightly from their relatively low levels to ensure that financial conditions remained conducive to sustained growth.

Certainly the May and June price figures have helped assuage concerns that new inflationary pressures had taken hold. Nonetheless, on balance, the news on inflation this year must be characterized as disappointing. Despite disinflationary forces and continued slack, the rate of inflation has at best stabilized, rather than easing further as past relationships would have suggested.

In assessing the stance of monetary policy and the likelihood of persistent inflationary pressures, the FOMC took account of the downshift in the pace of economic expansion earlier this year. This downshift left considerable remaining slack in the economy and promised that the adverse price movements prompted by the acceleration in growth late last year likely would diminish.

While a slowdown from the unsustainably rapid growth in the latter part of last year had been anticipated, the deceleration was greater than expected. A surprisingly precipitous drop in defense spending, a sharp deterioration in net exports, a major blizzard, and some inevitable retrenchment by consumers converged to yield only meager gains in output in the first quarter. But growth apparently picked up in the second quarter, and nearly one million net new jobs were created over the first half. Smoothing through the quarterly pattern, the economy appears to have accelerated gradually over the past two years, to maintain a pace of growth that should yield further reductions in the unemployment rate. Consequently, the evidence remains consistent with our diagnosis that the underlying forces at work are keeping the economy generally on a moderate upward track. However, as I have often emphasized, not all the old economic and financial verities have held in the current expansion, and changes in fiscal policy will have uncertain effects going forward. Thus, caution in assessing the path for the economy remains appropriate.

Financial conditions have improved considerably, lessening the need for balance sheet restructuring that has been damping economic activity for several years now. By no means is the process over, but good progress has been made. Debt service burdens, eased by lower interest rates and lower debt–equity ratios, have fallen substantially in both the business and household sectors. On the other hand, the economies of a number of our major trading partners have been quite weak, constraining the growth of demand for our exports.

Although expectations of a significant, credible decline in the budget deficit have induced lower long-term interest rates and favorably affected the economy, the positive influence thus far is apparently being at least partly offset by some business spending reductions as a consequence of concerns about the effects of pending tax increases.

It seems that the *prospective* cuts in the deficit are having a variety of substantial economic effects, well in advance of any *actual* change in taxes or in projected outlays. Moreover, uncertainty about the final shape of the package may itself be injecting a note of caution into private spending plans. In addition, uncertainty about the outlook for health care reform may be affecting spending at least by that industry.

To be sure, the conventional wisdom is that budget deficit reduction restrains economic growth for a time, and I suspect that probably is correct. However, over the long run, such wisdom points in the opposite direction. In fact, one can infer that recent declines in long-term interest rates are bringing forward some of these anticipated long-term gains. As a consequence, the timing and magnitude of any net restraint from deficit reduction is uncertain. Patently, the overall economic effect of fiscal policy, especially when combined with the uncertainties of the forthcoming health reform package, has imparted a number of unconventional unknowns to the economic outlook.

Assuming, however, we constructively resolve over time the major questions about federal budget and health care policies, with the further waning of earlier restraints on growth, the U.S. economy should eventually emerge healthier and more vibrant than in decades. The balance sheet restructuring of both financial and nonfinancial establishments in recent years should leave the various sectors of the economy in much better shape and better able to weather untoward developments. Similarly, the ongoing efforts by corporations to pare expenses are putting our firms and our industries in a better position to compete both within the U.S. market and globally. And after a period of some dislocation, the contraction in the defense sector ultimately will mean a freeing up of resources for more productive uses. Finally, a credible and effective fiscal package would promise an improved outlook for sustained lower long-term interest rates and a better environment for private sector investment. All told, the productive capacity of the economy will doubtless be higher, and its resilience greater.

Over the last two years, the forces of restraint on the economy have changed, but real growth has continued, with one sector of the economy after another taking the lead. Against this background, Federal Reserve Board governors and Reserve Bank presidents project that the U.S. economy will remain on the moderate growth path it has been following as the expansion has progressed. Their forecasts for real GDP average around 2½ percent from the fourth quarter of 1992 to the fourth quarter of 1993, and cluster around 2½ to 3¼ percent over the four quarters of 1994. Reflecting this moderate rise and the outlook for labor productivity, unemployment is generally expected to edge lower, to around 6¾ percent by the end of this year, and to perhaps a shade lower by the end of next year. For this year as a whole, FOMC participants see inflation at or just above 3 percent, and most of them have about the same forecast for next year.

In addition to focusing on the outlook for the economy at its July meeting, the FOMC, as required by the Humphrey–Hawkins Act, set ranges for the growth of money and debt for this year and, on a preliminary basis, for 1994. One premise of the discussion of the ranges was that the uncharacteristically slow growth of the broad monetary aggregates in the last couple of years—and the atypical increases in their velocities—would persist for a while longer. M2 has been far weaker than income and interest rates would predict. Indeed, if the historical relationships between M2 and nominal income had remained intact, the behavior of M2 in recent years would have been consistent with an economy in severe contraction. To an important degree, the behavior of M2 has reflected structural changes in the financial sector: The thrift industry has downsized by necessity, and commercial banks have pulled back as well, largely reflecting the burgeoning loan losses that followed the lax lending of earlier years. With depository credit weak, there has been little bidding for deposits, and depositors in any case have been drawn to the higher returns on capital market instruments. Inflows to bond and stock mutual funds have reached record levels, and, to the extent that these inflows have come at the expense of growth in deposits or money market mutual funds, the broad monetary aggregates have been depressed.

In this context, the FOMC lowered the 1993 ranges for M2 and M3—to 1 to 5 percent and 0 to 4 percent, respectively. This represents a reduction of 1 percentage point in the M2 range and ½ percentage point for M3. Even with these reductions, we would not be surprised to see the monetary aggregates finish the year near the lower ends of their ranges.

As I emphasized in a similar context in February, the lowering of the ranges is purely a technical matter; it does not indicate, nor should it be perceived as, a shift of monetary policy in the direction of restraint. It is indicative merely of the state of our knowledge about the factors depressing the growth of the aggregates relative to spending, of the course of the aggregates to date, and of the likelihood of various outcomes through the end of the year.

While the lowering of the range reflects our judgment that shifts out of M2 will persist, the upper end of the revised range allows for a resumption of more normal behavior or even some unwinding of M2 shortfalls. The FOMC also lowered the 1993 range for debt of the domestic nonfinancial sectors, by ½ percentage point, to 4 to 8 percent. The debt aggregate is likely to come in comfortably within its new range, as it continues growing about in line with nominal GDP. The new ranges for growth of money and debt in 1993 were carried over on a preliminary basis into 1994.

In reading the longer-run intentions of the FOMC, the specific ranges need to be interpreted cautiously. The historical relationships between money and income, and between money and the price level have largely broken down, depriving the aggregates of much of their usefulness as guides to policy. At least for the time being, M2 has been downgraded as a reliable indicator of financial conditions in the economy, and no single variable has yet been identified to take its place.

At one time, M2 was useful both to guide Federal Reserve policy and to communicate the thrust of monetary policy to others. Even then, however, a wide range of data was routinely evaluated to assure ourselves that M2 was capturing the important elements in the financial system that would affect the economy. The FOMC never single-mindedly adhered to a narrow path for M2, but persistent and sizable deviations of that aggregate from expectations were a warning sign that policy and the economy might not be interacting in a way that would produce the desired results. The so-called "P-star" model, developed in the late 1980s, embodied a long-run relationship between M2 and prices that could anchor policy over extended periods of time. But that long-run relationship also seems to have broken down with the persistent rise in M2 velocity.

M2 and P-star may reemerge as reliable indicators of income and prices once the yield curve has returned to a more normal configuration, borrowers' balance sheets have been restored and traditional credit demands resume, savers have adjusted to the enhanced availability of alternative investments, and depositories finally reach a comfortable size relative to their capital and earnings. In the meantime, the process of probing a variety of data to ascertain underlying economic and financial conditions has become even more essential to formulating sound monetary policy. This general approach obviously has its weaknesses. When examining many indicators, some can always be found that counsel against actions that later appear to have been necessary.

In these circumstances, it is especially prudent to focus on longer-term policy guides. One important guidepost is real interest rates, which have a key bearing on longer-run spending decisions and inflation prospects.

In assessing real rates, the central issue is their relationship to an equilibrium interest rate, specifically the real rate level that, if maintained, would keep the economy at its production potential over time. Rates persisting above that level, history tells us, tend to be associated with slack, disinflation, and economic stagnation—below that level with eventual resource bottlenecks and rising inflation, which ultimately engenders economic contraction. Maintaining the real rate around its equilibrium level should have a stabilizing effect on the economy, directing production toward its long-term potential.

The level of the equilibrium real rate—or more appropriately the equilibrium term structure of real rates—cannot be estimated with a great deal of confidence, though with enough to be useful for monetary policy. Real rates, of course, are not directly observable, but must be inferred from nominal interest rates and estimates of inflation expectations. The most important real rates for private spending decisions almost surely are the longer maturities. Moreover, the equilibrium rate structure responds to the ebb and flow of underlying forces affecting spending. So, for example, in recent years the appropriate real rate structure doubtless has been depressed by the head winds of balance sheet restructuring and fiscal retrenchment. Despite the uncertainties about the levels of equilibrium and actual real interest rates, rough judgments about these variables can be made and used in conjunction with other indicators in the monetary policy process. Currently, short-term real rates, most directly affected by the Federal Reserve, are not far from zero; long-term rates, set primarily by the market, are appreciably higher, judging from the steep slope of the yield curve and reasonable suppositions about inflation expectations. This configuration indicates that market participants anticipate that short-term real rates will have to rise as the head winds diminish, if substantial inflationary imbalances are to be avoided.

While the guides we have for policy may have changed recently, our goals have not. As I have indicated many times to this Committee, the Federal Reserve seeks to foster maximum sustainable economic growth and rising standards of living. And in that endeavor, the most productive function the central bank can perform is to achieve and maintain price stability.

Inflation is counterproductive in many ways. Of particular importance, increased inflation has been found to be associated with reduced growth of productivity, apparently in part because it confounds relative price movements and obscures price signals. Compounding this negative effect, under the current tax code, inflation raises the effective taxation of savings and investment, discouraging the process of capital formation. Since productivity growth is the only source of lasting increases in real incomes and because even small changes in growth rates of productivity can accumulate over time to large differences in living standards, its association with inflation is of key importance to policymakers.

The link between the control of inflation and the growth of productivity underscores the importance of providing a stable backdrop for the economy. Such an environment is especially important for an increasingly dynamic market economy, such as ours, where technology and telecommunications are making rapid advances. New firms, new products, new jobs, new industries, and new markets are continually being created, and they are unceremoniously displacing the old ones. The U.S. economy is a dynamic system, always renewing itself. It is extraordinary that the system overall is as stable as it is, considering the persistent process of change in the structure of our economy. For example, a frequently cited figure is the two million new jobs that have been created since the end of 1991. This is a net change, however, which masks the many millions who found, lost, and changed jobs over the same period. Currently, people are being hired at a pace of approximately 400,000 per week, with job losses running modestly below that figure. Such vast churning in the nation's labor markets is a normal and ultimately a productive process.

Central planning of the type that prevailed in post-war Eastern Europe and the Soviet Union represented one attempt to fashion an economic system that eliminated this competitive churning and its presumed wastefulness. But when that system eliminated the risk of failure, it also stifled the incentive to innovate and to prosper. Central planning fostered stasis: In many respects, the eastern-bloc economies marched in place for more than four decades.

Risk-taking is crucial in the process that leads to a vital and progressive economy. Indeed, it is a necessary condition for wealth creation. In a market economy, competition and innovation interact; those firms that are slow to innovate or to anticipate the demands of the consumer are soon left behind. The pace of churning differs by industry, but it is present in all. At one extreme, firms in the most high-tech areas must remain constantly on the cutting edge, as products and knowledge become rapidly obsolete. Many products that were at technology's leading edge, say five years ago, are virtually unsalable in today's markets. In high-tech fields, leadership can shift rapidly. In some markets where American firms were losing share just a few years ago, we have regained considerable dominance. In one case, U.S. firms have seized a commanding lead in just two years in the new laptop computer market, and now account for more than 60 percent of U.S. sales last year, triple the figure for Japanese firms.

More generally, it appears that the pace of dynamism has been accelerating. As one indication, the average economic life expectancy of new capital equipment has been falling. The average life of equipment purchased in 1982, for example, was 16½ years. By 1992 that figure had declined to 14½ years, a drop more than twice as large as that over the preceding decade. In addition, telecommunications technology is obviously quickening the decision-making process in both financial and product markets.

In such a rapidly changing marketplace, the agile survive by being flexible. One aspect of this flexibility has been the spread of "just-in-time" inventory controls at manufacturing firms. Partly as a result of innovations in inventory control techniques, the variability of inventories relative to total output appears to be on a downtrend.

The possibility of failure has productive side effects, encouraging economic agents to do their best to succeed. But there are nonproductive and unnecessary risks as well. There is no way to avoid risk altogether, given the inherently uncertain outcomes of all business and household decisions. But many uncertainties and risks do not foster economic progress, and where feasible should be suppressed. A crucial risk in this category is that induced by inflation. To allow a market economy to attain its potential, the unnecessary instability engendered by inflation must be quieted.

A monetary policy that aims at price stability permits low long-term interest rates and helps provide a stable setting to foster the investment and innovation by the private sector that are key to long-run economic growth. In pursuing our objectives, we must remain acutely aware that the structure of the economy has been changing and growing ever more complex. The relationships between the key variables in the economy are always shifting to a degree, and this evolution presents an ongoing challenge to the business leader, to the econometric modeler, and to those responsible for the conduct of economic policy.

Clearly, the behavior of many of the forces acting on the economy over the course of the last business cycle have been different from what had gone before. The sensitivity of inflation expectations has been heightened, and, as recent evidence suggests, businesses and households may be becoming more forward-looking with respect to fiscal policies as well.

I believe we are on our way toward reestablishing the trust in the purchasing power of the dollar that is crucial to maximizing and fulfilling the productive capacity of this nation. The public, however, clearly remains to be convinced: Survey responses and financial market prices embody expectations that the current lower level of inflation not only will not be bettered, it will not even persist. But there are glimmers of hope that trust is reemerging. For example, issuers have found receptive markets in recent months for fifty-year bonds. This had not happened in decades. The reopening of that market may be read as one indication that some investors once again believe that inflationary pressures will remain subdued.

It is my firm belief that, with fiscal consolidation and with the monetary policy path that we have charted, the United States is well-positioned to remain at the forefront of the world economy well into the next century.

Monetary Policy and the Economic Outlook for 1993 and 1994

Monetary Objectives for 1993 and 1994

In reviewing the annual ranges for the monetary aggregates in 1993, the FOMC noted that the relationship of broadly defined money to income has continued to depart from historical patterns. The annual velocities of these aggregates last fell in 1986, and their prolonged upward movements since then strongly suggest breaks from previous long-run trends of flat velocity for M2 and slowly decreasing velocity for M3. The rise in the velocity measures has been particularly surprising in the last four years, a period of declining interest rates, normally associated with a reduction in velocity.

In February, anticipating that further balance sheet restructuring and portfolio shifts from deposits to mutual funds would result in further increases in velocity, the FOMC lowered the 1993 growth ranges for M2 and M3 by one-half percentage point from the provisional ranges set in July 1992. In fact, velocities of the broad monetary aggregates have been especially strong; in the first quarter of 1993, the velocities of M2 and M3 posted substantial increases of 6¼ percent and 8 percent, respectively, and appear to have recorded additional, but smaller, gains in the second quarter. As a consequence, at its meeting this month, the Committee reduced the 1993 range for M2 by an additional percentage point and the range for M3 by another one-half percentage point, leaving them at 1 to 5 percent for M2 and 0 to 4 percent for M3.

The reductions of these growth ranges represented further technical adjustments in response to actual and anticipated increases in velocity and not a shift in monetary policy, which remains focused on fostering sustainable economic expansion while making continued progress toward price stability. With further substantial increases in velocities, continued sluggish expansion of M2 and M3,

Ranges for Growth of Monetary and Credit Aggregates[1]

(Percentage change, fourth quarter to fourth quarter)

	1992	1993 (As of February)	1993 (As of July)	1994
M2	2½ to 6½	2 to 6	1 to 5	1 to 5
M3	1 to 5	½ to 4½	0 to 4	0 to 4
Debt	4½ to 8½	4½ to 8½	4 to 8	4 to 8

which are now at the lower ends of their revised ranges, would be consistent with an acceptable track for the economy. Also at the July meeting, the annual monitoring range for the domestic nonfinancial debt aggregate was reduced by one-half percentage point to 4 to 8 percent; growth in this aggregate is likely to continue to be roughly in line with that of nominal GDP.

While the future behavior of the velocities of broad money aggregates was recognized to be difficult to predict with precision at a time of ongoing structural changes in the financial sector, it appears likely that the forces contributing to the unusual strength in velocities will continue for some time, and the FOMC carried forward the revised 1993 ranges for the monetary and debt aggregates to 1994 as well. With considerable uncertainty persisting about the relationship of the monetary aggregates to spending, the behavior of the aggregates relative to their annual ranges will likely be of limited use in guiding policy over the next eighteen months, and the Federal Reserve will continue to utilize a broad range of financial and economic indicators in assessing its policy stance.

Economic Projections for 1993 and 1994

The members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the Federal Open Market Committee, generally anticipate that economic activity will strengthen in the second half of 1993 and continue to expand moderately in 1994. The growth of output is likely to be accompanied by further gains in productivity, but increases in employment are projected to be large enough to keep the unemployment rate moving down. Inflation is not expected to change materially over this period.

Civilian Unemployment Rate

Economic Projections for 1993 and 1994

		FOMC Members and Other FRB Presidents	
1993		Range	Central Tendency
Percentage change, fourth quarter to fourth quarter:	Nominal GDP	4¾ to 6¼	5 to 5¾
	Real GDP	2 to 3½	2¼ to 2¾
	Consumer price index	3 to 3½	3 to 3¼
Average level in the fourth quarter, percent:	Civilian unemployment rate	6½ to 7	6¾
1994		Range	Central Tendency
Percentage change, fourth quarter to fourth quarter:	Nominal GDP	4½ to 6¾	5 to 6½
	Real GDP	2 to 3¼	2½ to 3¼
	Consumer price index	2 to 4¼	3 to 3½
Average level in the fourth quarter, percent:	Civilian unemployment rate	6¼ to 7	6½ to 6¾

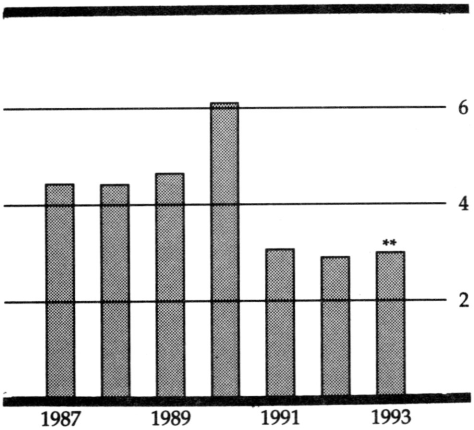
The forecasts of the Board members and Reserve Bank presidents for economic growth in 1993 are somewhat weaker than in February, mainly because of the shortfall in real growth in the first quarter. Most expect output gains over the balance of the year to be large enough to result in a four-quarter change in real gross domestic product in the range of 2¼ to 2¾ percent; for 1994, the central tendency of the forecasts spans a range of 2½ to 3¼ percent. The civilian unemployment rate, which averaged 7 percent in the second quarter of 1993, is projected to fall to the area of 6¾ percent by the fourth quarter of this year and to drop slightly further over the course of 1994.

Recent developments in the financial sphere should be conducive to the sustained increases in spending projected for the quarters ahead. The financial positions of many households and businesses have continued to improve, and banks are showing signs of greater willingness to make loans. Short-term interest rates are relatively low, and the appreciable declines in long-term interest rates over the past several months should further the process of balance sheet adjustment and are anticipated to provide considerable impetus to business investment and residential construction. It is likely that business investment also will continue to be bolstered by the ongoing push to improve products and boost efficiency through the use of state-of-the-art equipment. Moreover, with at least a moderate pickup in average growth in foreign industrial countries, the external sector should be exerting a less negative influence on economic activity in the United States.

Despite the improvement in financial conditions, there are reasons to be cautious about the near-term outlook. Efforts this year to bring the federal budget deficit under control already have helped to ease pressures on long-term interest rates, and a successful agreement to reduce deficits significantly will produce substantial benefits over the longer run. But such actions also are expected to exert some restraint on aggregate demand this year and next. Government outlays for defense will continue to contract, extending the dislocations and disruptions that have been evident for some time in industries and regions that depend heavily on military spending. Prospects for higher taxes may already be influencing the behavior of some households and businesses, and the constraint is likely to intensify in 1994. In addition, uncertainties about prospective federal policies reportedly are weighing on businesses and consumers; although the outcome of the Congressional budget deliberations will be known shortly, uncertainties about health care reform are not anticipated to be resolved fully for some time.

Consumer Prices*

Percent change, Dec. to Dec.



*Consumer price index for all urban consumers.
**Percent change, June 1992 to June 1993.

Most Board members and Bank presidents expect the rise in the consumer price index over the four quarters of 1993 to be in the range of 3 to 3¼ percent, about the same as the increase over the four quarters of 1992. At this stage, the food and energy sectors are not expected to have much effect, on balance, on the broad price measures in 1993, but the flooding in the Midwest raises the risk of higher food prices in the quarters ahead. For 1994, the central tendency forecast is for CPI inflation in the range of 3 to 3½ percent, not much different than in 1992 and 1993.

The fundamentals remain consistent with additional disinflation; businesses continue to focus on controlling costs, and slack in labor and product markets is anticipated to decrease only gradually in the period ahead. However, the disappointing price performance in the first half of the year suggests that further progress will not come easily—in part perhaps because inflation expectations remain high. Lowering inflation and inflation expectations over time, and achieving sustained reductions in long-term interest rates, will depend importantly on a monetary policy that remains committed to fostering further progress toward price stability. The performance of prices and the economy also will depend on government policies in other areas. Namely, a sound fiscal policy, a judicious approach to foreign trade issues, and regulatory policies that preserve flexibility and minimize the costs they impose are crucial to reestablishing the disinflation trend of the past couple of years and allowing the economy to perform at its full potential.

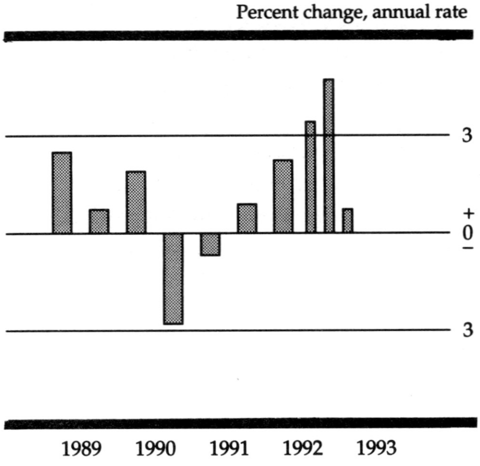
The Administration has not yet released the mid-year update to its economic and budgetary projections. However, statements by Administration officials suggest that the revised forecasts for real growth and inflation in 1993 and 1994 are not likely to differ significantly from those of the Federal Reserve.

Developments in 1993

In February, when the Federal Reserve prepared its monetary policy plans for 1993, the broad trends in the economy appeared favorable. After a hesitant beginning, the economic expansion had picked up steam in the latter part of 1992, while inflation seemed still to be headed downward. Most members of the Federal Open Market Committee (FOMC) and nonvoting presidents anticipated that 1993 would be a good year for growth and would also see further progress toward price stability.

As the year has unfolded, however, the economy's performance has fallen short of these expectations. Economic growth has slowed appreciably from the pace late last year; in part, this has reflected a retreat in business and consumer confidence and the effects on our trade balance of weakness in a number of other industrial countries.

Real GDP



Like most private forecasters, the Board members and Bank presidents generally have trimmed their projections of growth in real gross domestic product (GDP) for the year as a whole, although they continue to foresee increases in output large enough to extend the reduction in the unemployment rate that began last summer. Events on the price side also have been disappointing. The inflation rate in the first part of this year was higher than in late 1992. There is evidence that some of the pickup in the consumer price index (CPI) may have reflected difficulties in seasonal adjustment, and price data for the past couple of months have been much more favorable. Nonetheless, a broad array of indicators points to a leveling out of the underlying inflation trend.

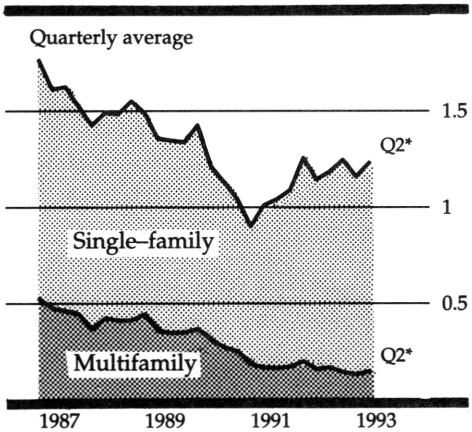
In this circumstance, and with short-term interest rates unusually low, especially when compared with inflation, the Federal Reserve recognized a need to be alert to the possibility that the balance of risks in the economy could shift soon in a direction dictating some firming of policy; failure to act in a timely manner could lead to a buildup of inflationary pressures, to adverse reactions in financial markets, and ultimately to the disruption of the growth process. To this point, however, the moderate thrust of aggregate demand and considerable slack in the economy, taken together with the more subdued price data of late, do not suggest that a sustained upswing in inflation is at hand.

Accordingly, the Federal Reserve has not adjusted its monetary policy instruments.

The pace of economic growth in the final quarter of 1992 was not expected to be sustained, but the slowing in the first quarter of 1993 was surprisingly sharp. With the exception of business fixed investment, the slowdown cut across the major categories of final demand. After stepping up their spending in late 1992, consumers became more pessimistic about their economic prospects and more cautious in their spending decisions; the uncertainty surrounding the efforts to reduce the federal deficit may have been a factor in the weakening of household sentiment. Housing activity, which also had been exceptionally strong late last year, hit a lull—even before the March blizzard on the East Coast—and real defense purchases plunged. Moreover, net exports deteriorated sharply, as exports declined and imports surged; the drop in exports was attributable in part to continued weak growth in some other industrial countries and in part was an adjustment to the big increase in late 1992.

Private Housing Starts

Annual rate, millions of units



*April–May average.

The more recent statistical indicators, taken together, point to a resumption of moderate growth in real GDP in the second quarter. Most notably, on the positive side, the increase in aggregate hours worked for the quarter as a whole—a useful indicator of movements in overall output—was the largest of the current expansion. Sales of motor vehicles also exhibited considerable vigor. But other key indicators were less robust. In particular, after allowing for the effects of the blizzard, consumer spending on items other than motor vehicles was lackluster, and housing activity improved only modestly. In the manufacturing sector, orders generally remained soft, and factory output, after having posted solid gains over the preceding seven months, is estimated to have declined somewhat over May and June.

Broad measures of inflation picked up in early 1993, with monthly increases through April in the upper part of the range of the past couple of years. Although readings on consumer and producer prices were much more favorable in May and June, the cumulative price and wage data for the year to date suggest that underlying inflation has flattened out, after trending down over the preceding two years. Excluding the especially volatile food and energy components, the twelve-month change in the CPI has held in the range of 3¼ to 3½ percent since the summer of 1992.

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 based on 1972–76 global trade of each of the 10 countries.

In financial markets, short-term interest rates have changed little so far in 1993, while intermediate- and long-term interest rates have fallen three-quarters to one percentage point to their lowest levels in over twenty years. The decline in longer-term rates seems largely to have been a response to the enhanced prospects for credible fiscal restraint, though the slower pace of economic expansion may also have played a role. Falling interest rates have helped stock market indexes set new records. Despite a decline in the dollar versus the yen, the average value of the dollar on a trade-weighted basis relative to G-10 currencies has risen, on balance, since the end of 1992. Although foreign intermediate-term interest rates have been down, on average, about as much as U.S. interest rates, short-term rates abroad have decreased substantially relative to U.S. rates, as foreign monetary authorities have taken steps to bolster weak economies.

Declining U.S. market interest rates contributed to robust growth in narrow measures of money and in reserves over the first half of the year, but broad monetary aggregates were very weak and their velocities continued to show exceptional increases. Credit demands on depositories remained quite subdued relative to spending, considerable depository credit was funded from nonmonetary sources, and savers continued to demonstrate a marked preference for capital market instruments over money stock assets.

In part owing to the drop in bond and stock yields, as well as to the desire to strengthen balance sheets, corporate borrowers have continued to concentrate credit demands on long-term securities markets, using the proceeds in part to repay bank loans; business loans at banks have not grown this year, although there were tentative signs of a pickup over May and June. Total lending and credit growth at banks has risen only slightly from the depressed pace of 1992, and these institutions have therefore not needed to pursue deposits. Thrifts have continued to contract, but at a much slower pace than in recent years.

Banks have eased lending standards for smaller firms for several quarters and recently relaxed standards for medium- and large-sized firms as well. An increased willingness to lend on the part of banks has been associated with considerably more comfortable capital positions. Banks have continued to strengthen their balance sheets by issuing large volumes of equity and subordinated debt, while retaining a substantial amount of earnings. As a result, the portion of the industry that is well-capitalized (taking account of supervisory ratings as well as capital ratios) increased from about one-third at the end of 1991 to more than two-thirds by March 1993.

In turning to equity and other nondeposit funds, banks have reduced the share of depository credit that is financed by monetary liabilities. Depositors, for their part, have continued to shift funds into capital markets, attracted by still-high returns in these markets relative to earnings on deposits. Inflows into bond and equity mutual funds have run at record levels this year, and banks have facilitated investing in mutual fund products by increasingly offering them in their lobbies. As a consequence of these various forces, M2 increased at only a ¾ percent annual rate from its fourth-quarter 1992 average through June, while M3 fell slightly. The sum of M2 and estimated household holdings of long-term mutual funds grew at about a 4¾ percent rate from the fourth quarter through June, little changed from the pace of recent years.

Debt growth has edged up this year, despite a deceleration in nominal spending, perhaps buoyed by improvements in financial positions achieved over the past few years by both borrowers and lenders. Investment outlays are estimated to have exceeded the internal funds of corporations for the first time in two years, while household borrowing has picked up relative to spending. In addition, Treasury financing needs have remained heavy. Nevertheless, nonfinancial debt growth has been running at only a 5 percent rate this year.

Growth of Money and Debt

		M1	M2	M3	Total domestic nonfinancial debt	Nonfederal domestic nonfinancial debt
				(Percentage changes)		
Annually, Fourth quarter to fourth quarter	1980	7.4	8.9	9.5	9.5	9.0
	1981	5.4 (2.5)[1]	9.3	12.3	10.0	9.7
	1982	8.8	9.1	9.9	9.3	7.4
	1983	10.4	12.2	9.9	11.4	8.8
	1984	5.5	8.1	10.8	14.3	13.9
	1985	12.0	8.7	7.6	13.8	13.3
	1986	15.5	9.3	8.9	14.0	13.7
	1987	6.3	4.3	5.8	10.1	10.4
	1988	4.3	5.3	6.4	9.2	9.6
	1989	0.6	4.7	3.7	8.2	8.5
	1990	4.3	4.0	1.8	6.8	5.9
	1991	8.0	2.8	1.1	4.4	2.5
	1992	14.3	1.8	0.3	4.8	2.9
Semiannually 1993 *(annual rate)*[2]	H1	8.7	0.1	–0.7	5.1	3.3
Quarterly 1993 *(annual rate)*[2]	Q1	6.6	–2.0	3.8	4.4	3.0
	Q2	10.6	2.2	2.4	5.7	3.6
Fourth quarter 1992 to June 1993 *(annual rate)*		9.5	0.8	–0.3	5.1[3]	3.3[3]

1. Adjusted for shift to NOW accounts in 1981.
2. From average for preceding quarter to average for quarter indicated. Second quarter debt aggregates estimated on data through May.
3. 1992: Q4–1993: May for debt aggregates.

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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