1994 MONETARY POLICY OBJECTIVES

MIDYEAR REVIEW OF THE FEDERAL RESERVE BOARD

JULY 20, 1994

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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.

JULY 20, 1994

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Monetary Policy and the Economic Outlook for 1994 and 1995

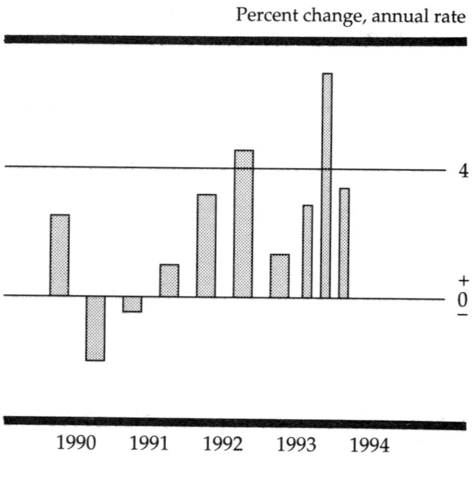
The U.S. Economy

The favorable performance of the U.S. economy continued in the first half of 1994. Economic activity advanced at a brisk pace, building on the substantial gains in late 1993, and broad measures of inflation moved still lower. Unemployment declined, and industrial capacity utilization rose, substantially reducing the remaining slack in resource use.

In this context, monetary policy has been directed this year at heading off a buildup of inflationary pressures that could jeopardize the continuation of the economic expansion. To do so, the Federal Reserve has had to move away from its highly accommodative policy stance of recent years. That stance had been adopted to counteract unusual restraint on domestic spending associated in large part with the efforts of both borrowers and lenders to strengthen their financial condition. Data available in late 1993 and early 1994 suggested that the restraint on spending had dissipated and that the economic expansion had become strong and self-sustaining. Against this background, the Federal Reserve has firmed money market conditions in four steps this year.

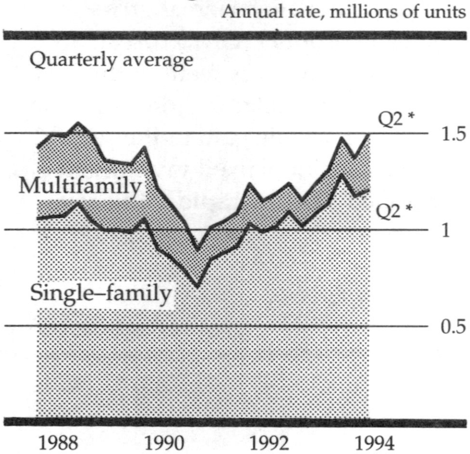
Despite disruptions caused by severe winter storms, real gross domestic product (GDP) rose at an annual rate of 3½ percent in the first quarter, and available indicators point to another sizable gain in the second quarter. Business fixed investment has continued to grow rapidly this year,

Real GDP



as firms have sought to improve efficiency by installing state-of-the-art equipment; rising utilization rates have spurred interest in expansion of capacity as well. Consumer outlays have trended higher this year, buoyed by the considerable gains in income and an increased willingness to borrow or use savings; lately, though,

Private Housing Starts

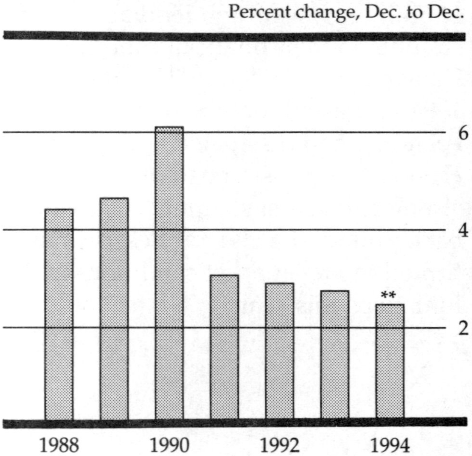


* April–May average.

spending growth appears to have moderated somewhat. The rise in long-term interest rates that began last fall has damped the growth of housing activity this year, but the effect has been relatively mild, in part because homes remain quite affordable by the standards of the past two decades. In the labor market, the employment gains during the first half of this year were substantially more rapid than in 1993, and the unemployment rate has continued to move lower.

Inflation generally was moderate during the first half of 1994. Retail food and energy prices changed little, on balance, over this period, holding the rise in the consumer price index (CPI) to 2½ percent at an annual rate. At the same time, prices for a wide range of materials used in manufacturing and construction have been boosted considerably by strong demand and the resulting higher rates of resource utilization. Looking ahead, retail energy prices likely will rise over the summer, pushed up by the rebound in crude oil prices in recent months; in addition, the decline in the dollar since the beginning of the year, if not reversed, probably will exert some upward pressure on prices.

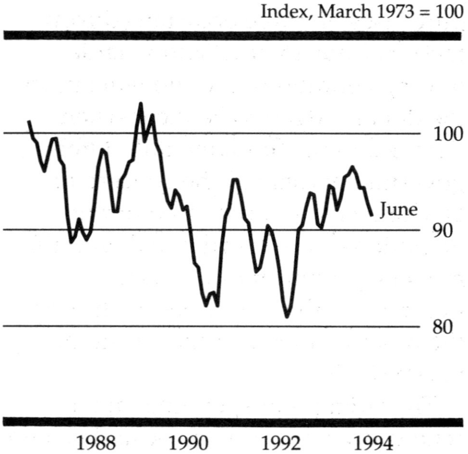
Consumer Prices *



* Consumer price index for all urban consumers.
** Percent change, December 1993 to June 1994.

The Federal Reserve's policy actions this year have raised the federal funds rate to around 4¼ percent, from 3 percent, and have boosted the discount rate to 3½ percent, also from 3 percent. Other market interest rates have risen 1¼ to 1¾ percentage points since the beginning of the year. Increases in intermediate- and long-term rates have been unusually large relative to the adjustment of short-term rates, reflecting stronger-than-anticipated economic growth and market expectations of greater inflationary pressures, as well as actual and expected tightening actions by the Federal Reserve to contain those pressures. On occasion, the declining value of the dollar also appeared to contribute to higher yields. Markets have been volatile at times this year as investors have adjusted to a changing economic and policy outlook. The uncertain conditions encouraged investors to try to reduce their risk exposure, and the associated attempts to make large shifts in portfolios over short periods seemed to add to the upward pressure on long-term rates at times.

Foreign Exchange Value of the U.S. Dollar *



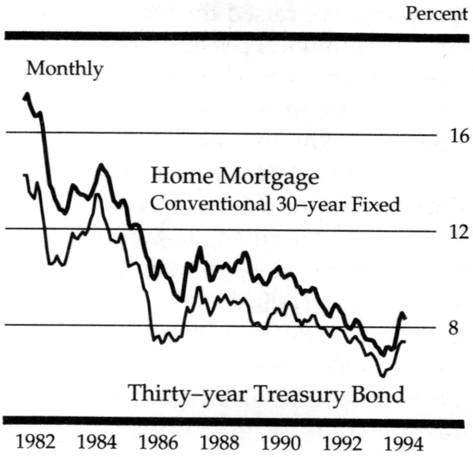
* Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of other G–10 countries. Weights are based on 1972–76 global trade of each of the 10 countries.

Despite the rise in U.S. interest rates, the dollar has declined considerably this year, with its trade-weighted foreign exchange value against the Group of Ten (G-10) countries falling about 8 percent. Rising long-term interest rates abroad, associated with brighter prospects for economic growth, tended to offset the effect on the dollar of higher U.S. rates. Moreover, other factors, including diminished hopes for a prompt resolution of trade tensions with Japan and market concerns about future inflation in the United States, fostered downward pressure on the dollar. This pressure was especially intense in late April and early May and again in the second half of June and first half of July.

The U.S. Treasury and the Federal Reserve made substantial dollar purchases on three occasions during these periods to deal with volatile trading conditions and movements in the dollar judged to be inconsistent with economic fundamentals. Other governments shared the concern of U.S. officials, and the more recent operations were coordinated with the monetary authorities of a large number of other countries, including the other members of the Group of Seven (G-7).

The strength of spending and a renewed willingness to use and extend credit contributed to a pickup in borrowing by households and businesses in the second half of last year, and this trend extended into the first half of 1994. However, the composition of borrowing has been affected by financial market conditions. Rising and more volatile long-term interest rates have encouraged businesses to rely more heavily on sources of shorter-term financing, such as finance companies and banks, and have prompted households to shift to adjustable rate mortgages. Banks, which had been hampered by balance-sheet problems of their own in recent years, sought business and household loans more aggressively by continuing to ease credit standards and the nonprice terms of lending. Total commercial bank credit has increased considerably this year, and thrift institution credit, which contracted sharply between 1989 and 1993, appears to have expanded a bit.

Long–Term Interest Rates



In contrast to the strength of private borrowing, the growth of federal government debt has slowed this year, reflecting the subdued growth of expenditures and sharply higher tax receipts associated with fiscal policy actions and the robust economy. As a result, the total debt of the domestic nonfinancial sectors expanded at about a 5¼ percent annual rate from the fourth quarter of 1993 through May, close to its pace over the second half of last year and well within its monitoring range of 4 to 8 percent.

Growth of the broad money aggregates has not kept pace with that of nominal GDP again this year. M2 increased at about a 1¼ percent annual rate from the fourth quarter of last year through June, while M3 fell slightly, placing these aggregates around the lower bounds of their respective annual growth ranges.

In the usual pattern, increases in rates on retail deposits and on money market mutual funds have lagged the rise in market interest rates, inducing a redirection of savings from M2 into market instruments and boosting M2 velocity. With returns on interest-paying checking accounts virtually unchanged, compensating balance requirements for demand deposits reduced by rising rates, and transactions balances also depressed by several special influences, M1 growth this year has slowed to less than half its rate of advance in 1993; through June, this aggregate had expanded at about a 4 percent annual rate since the fourth quarter of last year. Owing to the anemic expansion of transactions deposits, total reserves fell slightly over the first half of the year. Only continued strong demand for currency, much of which reflected use abroad, has supported growth in M1 and the monetary base.

In contrast to 1992 and 1993, shifts into bond and stock mutual funds were not a major factor in the rise in M2 velocity this year. Falling securities prices created capital losses for bond and equity mutual funds, prompting some fund holders to reevaluate the risks and prospective returns of such investments. Bond mutual funds experienced outflows this spring, and a portion of the proceeds was directed to less-risky money market mutual funds, thus elevating M2 for a time. Even with more subdued moves in securities prices since the late spring, many small investors have retained a more cautious view of the possible risks and rewards of holding capital market instruments, and total inflows to bond and stock mutual funds have remained considerably weaker than in the past few years. The effect of these slower flows on M2 has been offset by shifts into direct holdings of market instruments, such as Treasury bills. As a consequence, the sum of M2 and household holdings of bond and stock mutual funds has decelerated sharply this year.

Economic Projections for 1994 and 1995

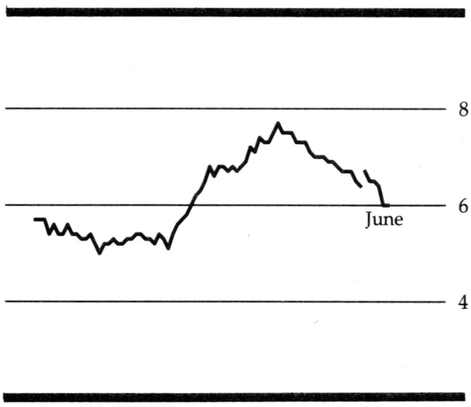
The members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the Federal Open Market Committee, generally anticipate that the growth of real GDP will moderate during the second half of this year and into 1995 from the unsustainable pace in recent quarters. Employment gains through the end of 1995 are expected roughly to balance the net flow of individuals into the labor force, leaving the unemployment rate about unchanged from its average level in the second quarter of this year. Inflation is expected to pick up a little over the next year and one-half.

The forecasts of the Board members and Reserve Bank presidents for economic growth in 1994 are quite close to those made in February. Most continue to expect that real GDP will rise 3 to 3¼ percent over the four quarters of this year. For 1995, the central tendency of the forecasts is a range of 2½ to 2¾ percent.

Economic Projections for 1994 and 1995

		FOMC Members and Other FRB Presidents		**Administration**
1994		Range	Central Tendency	
Percentage change, fourth quarter to fourth quarter	Nominal GDP	5¼ to 6½	5½ to 6	5.8
	Real GDP	3 to 3½	3 to 3¼	3.0
	Consumer price index	2½ to 3½	2¾ to 3	2.9
Average level in the fourth quarter, percent	Civilian unemployment rate	6 to 6¼	6 to 6¼	6.2
1995		Range	Central Tendency	
Percentage change, fourth quarter to fourth quarter	Nominal GDP	4½ to 6¼	5 to 5½	5.6
	Real GDP	2¼ to 2¾	2½ to 2¾	2.7
	Consumer price index	2 to 4½	2¾ to 3½	3.2
Average level in the fourth quarter, percent	Civilian unemployment rate	5¾ to 6½	6 to 6¼	6.2

Civilian Unemployment Rate *



* Data after December 1993 are not consistent with earlier data because of major revisions to the survey from which the series is generated.

The unemployment rate anticipated in the fourth quarter of 1994 has been revised down about ½ percentage point from that projected in February.[1] The forecasts of the unemployment rate in the fourth quarter of 1994 are now bunched between 6 and 6¼ percent; this range is also the central tendency of the projections for the fourth quarter of 1995.

These forecasts envision the next several quarters as a period of transition to a more moderate expansion accompanied by reasonably full use of available resources. This transition already is evident in the housing market and, perhaps, in consumer outlays as well. The resulting deceleration in private domestic spending is expected to be offset, in part, by a smaller decline in net exports than that registered over the past several quarters; this projection for the external sector largely reflects the expectation of stronger economic expansion abroad.

The Board members and Reserve Bank presidents generally expect the rise in the consumer price index over the four quarters of 1994 to end up in the range of 2¾ to 3 percent. So far this year, retail energy prices have been flat on balance and retail food prices have moved up only a little, restraining the rise in the total CPI. However, given the runup in crude oil prices of late and the unlikely prospect of another large drop in the prices of fruits and vegetables, the rate of inflation projected for the next year and one-half is slightly higher than that posted recently. The decline in the dollar to date, if not reversed, also could exert some mild upward pressure on inflation.

1. The unemployment forecast in February was subject to an unusual degree of uncertainty, as it was made shortly after the introduction of major revisions to the survey that generates the unemployment data. In February, the revised survey was believed to have boosted the unemployment rate from January 1994 forward by roughly ½ percentage point. Subsequent analysis has indicated that the upward shift caused by the new survey probably was smaller than originally thought.

The Administration recently released its mid-year update of economic and budgetary projections. The projections for nominal and real GDP growth, inflation, and unemployment for 1994 and 1995 fall within the ranges anticipated by Federal Reserve officials and are essentially consistent with the central tendency of those ranges. Thus, it would appear that the monetary ranges set by the FOMC are compatible with the goals of the Administration.

Both Federal Reserve policymakers and the Administration anticipate further economic expansion accompanied by relatively low inflation. The Federal Reserve can do its part to prolong and enhance this favorable performance of the economy by continuing to set monetary policy in accord with the long-run objective of price stability. An environment of stable prices is a necessary condition for attaining the maximum sustainable growth of productivity and living standards. However, the outcome for the economy also will depend on government policy in other areas. In this regard, Congress and the Administration can help ensure that the nation's economy reaches its full potential by working to keep the federal budget deficit on a downward course, by promoting an open world trading system, and by adopting regulatory policies that preserve the flexibility of labor, product, and financial markets and minimize the costs imposed on the private sector.

Money and Debt Ranges for 1994 and 1995

At its July 1994 meeting, the Federal Open Market Committee (FOMC) reviewed the annual ranges for money growth for 1994 that it had established in February. In light of the experience of the first half of the year and the likelihood that funds would continue to be diverted from deposits to higher yielding market instruments, the Committee expected a substantial increase in the level of M2 velocity over 1994. M3 velocity also was seen as likely to rise quite sharply, given the funding patterns of depository institutions, which had been favoring sources of funds not included in M3, such as capital and borrowing from overseas offices.

Ranges for Growth of Monetary and Credit Aggregates[1]

Percent

Aggregate	1993	1994	Provisional for 1995
M2	1–5	1–5	1–5
M3	0–4	0–4	0–4
Debt[2]	4–8	4–8	3–7

1. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.
2. Monitoring range for debt of domestic nonfinancial sectors.

As a consequence, the Committee continued to expect that money growth within, though perhaps toward the lower end, of the ranges of 1 to 5 percent for M2 and 0 to 4 percent for M3 would be consistent with its broader objective of fostering financial conditions that would sustain economic expansion and contain price pressures. It therefore voted to retain these ranges for 1994. With little information to suggest any new trends in velocity for 1995, the Committee chose simply to carry forward the 1994 ranges for M2 and M3 as provisional ranges for those aggregates in 1995. The Committee noted that these ranges, especially that for M2, provided an indication of the longer-run growth that might be expected in this aggregate with the attainment of reasonable price stability and a return to the past pattern of velocity fluctuating around a constant long-run level. Considerable uncertainty about the behavior of velocity is likely to persist, however, and the FOMC will continue to monitor a broad range of financial and economic indicators in addition to the monetary aggregates, when determining the appropriate stance of policy.

The Committee also decided to retain its current monitoring range of 4 to 8 percent for growth in the debt aggregate during 1994. With debt expanding at a rate close to that of nominal income, the FOMC's expectation for the growth in nominal GDP for the year suggested that the debt aggregate would finish the year comfortably within this range. In 1995, however, the Committee expected that macroeconomic performance consistent with sustainable expansion would involve some slowing in the growth of nominal spending and moderate growth in debt; indeed, rapid credit growth might suggest the possibility of a borrow-and-spend psychology typical of strengthening inflation. Consequently, the Committee voted to set provisionally the 1995 monitoring range for debt growth at 3 to 7 percent, a reduction of 1 percentage point.

Growth of Money and Debt

Percent

Period		M1	M2	M3	Domestic Nonfinancial Debt
Annual[1]	1980	7.4	8.9	9.6	9.1
	1981	5.4 (2.5)[2]	9.3	12.4	9.9
	1982	8.8	9.2	9.9	9.6
	1983	10.4	12.2	9.9	12.0
	1984	5.5	8.1	10.9	14.0
	1985	12.0	8.7	7.6	14.2
	1986	15.5	9.3	8.9	13.4
	1987	6.3	4.3	5.7	10.3
	1988	4.3	5.3	6.3	9.0
	1989	0.6	4.8	3.8	7.8
	1990	4.2	4.0	1.7	6.6
	1991	7.9	2.9	1.2	4.6
	1992	14.3	1.9	0.5	5.0
	1993	10.5	1.4	0.6	5.0
1994 Semiannual *(annual rate)*[3]	H1	4.0	1.6	−0.1	5.4[4]
1994 Quarter *(annual rate)*[5]	Q1	6.0	1.8	0.2	5.9
	Q2	2.0	1.5	−0.3	4.7[4]

1. From average for fourth quarter of preceding year to average for quarter of year indicated.
2. Figure in parentheses is adjusted for shifts to NOW accounts in 1981.
3. From average for fourth quarter of 1993 to average for second quarter of 1994.
4. Second quarter debt aggregate based on data through May.
5. From average for preceding quarter to average for quarter indicated.

Testimony of Alan Greenspan
Chairman, Federal Reserve Board

Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss with you recent economic developments and the Federal Reserve's conduct of monetary policy.

The favorable performance of the economy continued in the first half of 1994. Economic growth was strong, unemployment fell appreciably, and inflation remained subdued. To sustain the expansion, the Federal Reserve adjusted monetary policy over recent months so as to contain potential inflation pressures.

Our actions this year can be understood by reference to policy over the previous several years. Through that period, the Federal Reserve moved toward and then maintained for a considerable time a purposefully accommodative stance of policy. During 1993, that stance was associated with low levels of real short-term interest rates--around zero. We judged that low interest rates would be necessary for a time to overcome the effects of a number of factors that were restraining the economic expansion, including heavy debt burdens of households and businesses and tighter credit policies of many lenders. By early this year, however, it became clear that many of these impediments had diminished and that the economy had consequently gained considerable momentum. In these circumstances, it was no longer appropriate to maintain an accommodative policy. Indeed, history strongly suggests that maintenance of real short-term rates at levels prevailing last year ultimately would have fueled inflationary pressures.

Accordingly, the Federal Open Market Committee at its meeting in early February decided to move away from its accommodative posture by tightening reserve market conditions. Given the level of real short-term rates and the evident momentum in the economy, it seemed likely that a substantial cumulative adjustment of policy would be needed.

However, Committee members recognized that financial markets were not fully prepared for this action. About five years had passed since the previous episode of monetary firming, and a number of market participants in designing their investment strategies seemed to give little weight to the possibility that interest rates would rise; instead, many apparently extrapolated the then-recent, but highly unusual, extended period of low short-term interest rates, fairly steady capital gains on long-term investments, and relatively stable conditions in financial markets. Many Committee members were concerned that a marked shift in the stance of policy, while necessary, could precipitate an exaggerated reaction in financial markets.

With this in mind, we initially tightened reserve conditions only slightly—just enough to raise the federal funds rate ¼ percentage point. And the financial markets did indeed react sharply, with substantial increases in longer-term interest rates and declines in stock prices. Markets remained unsettled for several months, and we continued to move cautiously in March and April in the process of moving away from our accommodative stance. By mid-May, however, a considerable portion of the adjustment in portfolios to the new rate environment appeared to have taken place. With financial markets evidently better prepared to absorb a larger move, the Federal Reserve could substantially complete the removal of the degree of monetary accommodation that prevailed throughout 1993. The Board raised the discount rate ½ percentage point, a move that was fully passed through to reserve market conditions by the FOMC. Overall, the federal funds rate increased 1¼ percentage points during the first half of the year, and real short-term rates likely rose a similar amount. Partly to minimize any market confusion about the extent of and rationale for our moves, the Federal Reserve has announced each action and, in relevant instances, provided an explanation. At its meeting in early July, the FOMC faced considerable uncertainty about the pace of expansion and pressures on prices going forward, and it made no further adjustment in its policy stance.

Nonetheless, it is an open question whether our actions to date have been sufficient to head off inflationary pressures and thus maintain favorable trends in the economy. Labor demand has been quite strong, pointing to robust growth in production and incomes. To be sure, some hints of moderation in the growth of domestic final demand have appeared, and the recent indications of accelerating inventory accumulation may suggest an unwanted backing up of stocks.

Conversely, the inventory accumulation may reflect pressures on firms who had brought inventories down to suboptimal levels and now need to replenish them. In the latter case, stock-building may continue at an above-normal rate, supporting production for quite some time. Moreover, the improving economic conditions of our trading partners should add impetus to aggregate demand from the external sector.

How these forces balance out in the coming months could be critical in determining whether inflation will remain in check, for the amount of slack in the economy, while difficult to judge, appears to have become relatively small. Concerns that productive capacity could come under pressure and prices accelerate are already evident in commodity and financial markets, including the foreign exchange market. An increase of inflation would come at considerable cost: We would lose hard-won ground in the fight against inflation expectations—ground that would be difficult to recapture later; our long-run economic performance would be impaired by the inefficiencies associated with higher inflation if it persisted; and harsher policy actions would eventually be necessary to reverse the upsurge in inflationary instabilities. We are determined to prevent such an outcome, and currently are monitoring economic and financial data carefully to assess whether additional adjustments are appropriate.

The economic figures that have formed the backdrop for our policy actions so far this year confirm that a rapid expansion has been in progress. Following growth at an annual rate of 7 percent in the fourth quarter of last year, real gross domestic product rose at nearly a 3½ percent rate in the first quarter. A conceptually equivalent measure of aggregate output, gross domestic income, exhibited even larger gains in the fourth and first quarters. At this stage, available data leave some uncertainty regarding the pace of economic activity over the past three months. Nonetheless, the evidence in hand makes it reasonably clear that growth remained appreciably above its longer-run trend. The robust expansion over the first half of 1994 has been reflected in substantial increases in employment. Since last December, nonfarm payrolls have risen by 1¾ million workers, bringing the gain in jobs since the expansion got underway to 5 million. Reflecting this hiring, the civilian unemployment rate has fallen to 6 percent.

Although labor markets have tightened considerably in recent months, aggregate measures of wage and compensation rates have not yet evidenced persuasive signs of acceleration. Similarly, the increases in the consumer price index excluding food and energy, at about a 3 percent rate over the last six months, have remained near last year's pace, while the overall CPI has risen at a reduced rate of about 2½ percent.

To be sure, price pressures have been manifest at earlier stages of processing: Costs of many commodities and materials have been climbing, in some cases reflecting the tightening of industrial capacity utilization, which is now at its highest level in five years. But these pressures have been offset by favorable trends in unit labor costs resulting from marked improvements in productivity—especially in manufacturing—in recent years.

The accumulating evidence of stronger-than-expected economic growth here and abroad, combined with changing expectations of policy actions by the Federal Reserve as well as other central banks, prompted considerable increases in long-term interest rates in occasionally volatile markets over the first half of the year. Market participants concluded that, with aggregate demand stronger, higher real rates would be necessary to hold growth to a sustainable pace. Inflation expectations may also have been revised higher, as the performance of the economy seemed to make further near-term progress against inflation less likely and raised questions about whether price pressures might intensify.

To a degree, the very volatility of markets probably augmented the backup in long-term interest rates. One of the effects of the extended market rallies of recent years was to promote a rather complacent view among investors about the risks of holding long-term assets. In response, they gradually increased the proportions of their portfolios devoted to stocks and bonds, driving up their prices still further and narrowing risk spreads. But when developments earlier this year surprised investors and diminished their confidence in predicting future market conditions, they pulled back from long positions in securities until returns rose to compensate them for the additional price risk.

The recent weakness in bond prices was not limited to the United States, but was accompanied by a surge in foreign interest rates. This surge was particularly informative; ordinarily one would expect that as interest rates go up in one country, they would not increase to the same extent in others because exchange rates also would be expected to adjust. The initial jump in foreign interest rates was a sign of the extraordinary increase in uncertainty as, evidently, investors attempted to reduce their price-sensitive long positions by selling stocks and bonds regardless of currency denomination or economic conditions in the country of issuance. Roughly concurrently, moreover, signs that the slump in some foreign industrial economies was ending also were becoming apparent.

As a result, market participants anticipated stronger credit demands abroad and a reduced likelihood of further easing by some foreign central banks, and intermediate- and longer-term rates in many of our trading partners rose as much as or more than in the United States.

Rising foreign interest rates, concerns in markets about the prospects for reduced trade tensions and about U.S. inflation contributed to considerable activity directed at rebalancing international investment portfolios. One effect of this activity appears to have been a substantial decline of the foreign exchange value of the dollar on net over the past six months. Foreign exchange rates are key prices in the American economy, with significant implications for the volumes of exports and imports as well as for the prices of imports and domestically produced items that compete with imports. The foreign exchange value of the dollar also can provide useful insights into inflation expectations. If we conduct an appropriate monetary policy—and appropriate economic policies more generally—we shall achieve our goals of solid economic growth and price stability, and such economic results will ensure that dollar-denominated assets remain attractive to global investors, which is essential to the dollar's continuing role as the world's principal reserve currency.

Rising interest rates and considerable volatility in financial markets do not seem to have slowed overall credit flows this year. At about a 5¼ percent annual rate through May, domestic nonfinancial sector debt has increased within its 4-to-8 percent monitoring range. The composition of debt growth, however, has differed from the patterns of the previous few years. Expansion of federal debt has slowed as the actions of the Congress and the Administration as well as cyclical forces have narrowed the budget deficit considerably. The total debt of businesses, households, and state and local governments, by contrast, has risen this year at a brisker pace, though growth has remained quite moderate in comparison with the average experience of recent decades. The pickup this year indicates both that private borrowers have become less cautious about taking on debt and that lenders have become more comfortable lending to them. Although household debt-income ratios remain high, debt-service burdens have fallen appreciably, partly reflecting the refinancing of mortgages at lower interest rates. The lower debt burdens evidently have fostered a more favorable attitude toward credit among households, and consumer installment borrowing has accelerated, with strong growth of consumer loans at banks. Banks have been increasingly willing to extend credit, easing their terms and standards on business loans considerably.

In addition, some firms have turned to banks for financing because of the turbulence in bond and stock markets this spring. Total bank lending has strengthened materially and, with continued acquisitions of securities, total bank credit has picked up as well. Nonetheless, growth of the monetary aggregates remains damped, as banks have relied heavily on non-deposit sources of funds to finance loan growth.

Expansion of M2 has been quite slow this year, leaving this aggregate near the lower end of its 1-to-5 percent annual range. M3 actually has edged down, and thus is just below its 0-to-4 percent range for 1994. The weakness in the broader aggregates has not been reflected in the growth of income again this year, representing a continuation of the substantial increases in velocity that we have experienced over the past few years. The factors behind this behavior, however, have changed somewhat. The diversion of savings funds from deposits to bond and stock mutual funds, which sharply depressed money growth in past years, seems to have slowed substantially; the experience with capital losses this spring apparently has heightened some investors' appreciation of the risks of such instruments. On the other hand, rising short-term market interest rates, combined with the usual lag in the adjustment of deposit rates, have been a significant restraint on growth of the aggregates this year, in contrast to 1992 and 1993.

The increases in market rates this year have exerted a particular drag on the narrower monetary aggregates, as well as on the closely related reserves and monetary base measures. M1 has expanded at only a 4 percent rate so far this year, compared with 10½ percent increases in each of the previous two years. M1's velocity has continued to fluctuate sharply, limiting its usefulness in formulating and interpreting monetary policy. The growth of M1 this year would have been even lower were it not for continued heavy demands for U.S. currency abroad. Flows of currency overseas have an even greater effect proportionately on the monetary base, which has growth rapidly this year despite declines in the reserves of depository institutions.

In reviewing its ranges for money growth in 1994, the FOMC noted that further increases in velocity of M2 and M3 were likely. Although yields on deposits will probably continue to rise further in lagged response to increases in market rates, the wider rate disadvantage of deposits is likely to persist, and savers will continue to redirect flows into market instruments. As a result, growth of both aggregates near the lower bounds of their 1994 ranges is considered to be consistent with achieving our objectives for economic performance, and the ranges were left unchanged.

The Committee also decided on a provisional basis to carry forward the current ranges for the monetary aggregates to 1995. We were not confident that we could predict with sufficient accuracy the money-income relationships that were likely to prevail next year to modify the ranges. Moreover, further permanent reductions of the monetary ranges did not seem necessary, as those ranges are already low enough to be consistent with the goal of price stability and maximum sustainable economic growth, assuming an eventual return to more stable velocity behavior. From that point of view, we felt that maintenance of the current monetary ranges would give the clearest indication of the long-run intentions of policy.

Regarding domestic nonfinancial sector debt, we made no adjustment to this year's monitoring range, but elected to set a provisional monitoring range for 1995 of 3 to 7 percent, a percentage point lower than this year's. A lower range would conform with some deceleration in nominal income, in the process of containing inflation and ultimately making progress toward price stability. The reduction is not intended to signal an increased emphasis on the debt measure, but it is supported by our view that rapid debt growth, if sustained, can eventually lead to significant imbalances that are inimical to stable, noninflationary growth.

As usual, we shall review carefully all of the provisional ranges for 1995 in February.

Given the rapid pace of financial change, considerable uncertainties continue to attend the relationships of all of the aggregates to the performance of the economy and inflation, and we do not expect in the near term to increase the weight accorded in policy formulation to these measures. However, the processes of portfolio reallocation that have generated these recent shifts may be slowing. We shall continue to monitor monetary growth, and financial flows more generally, for information about the course of the economy and prices in coming to decisions regarding adjustments to the stance of monetary policy.

We expect that expansion of money and credit within the ranges we have established will be consistent with continuation of good economic performance. With appropriate monetary policies, the Board members and Reserve Bank Presidents see the economy settling into more moderate rates of growth over the next six quarters and inflation remaining relatively subdued. Specifically, the central tendencies of our forecasts are for real GDP to expand 3 to 3¼ percent over 1994 and 2½ to 2¾ percent next year. The consumer price index is projected to increase 2¾ to 3 percent this year.

In 1995, inflation may be about the same as in 1994 or slightly higher; the recent depreciation in the dollar is likely to put upward pressure on inflation over the next year if it is not reversed. With the pace of hiring likely to about match that of labor force growth, the unemployment rate is expected to remain close to its recent level.

Mr. Chairman, you also asked for economic projections for 1996. I fully appreciate your purpose in requesting this information. However, my colleagues and I don't think we can best communicate our policy intentions through additional numerical forecasts. Rather, we believe our intentions are best conveyed in terms of our declared objective of fostering as much growth of output and employment as can be achieved without placing destabilizing inflationary pressures on productive resources. There is considerable uncertainty about what that goal implies for the expansion of GDP and rates of unemployment.

That said, it may be useful to note that the assumptions underlying the medium-term projections provided to you by the Administration and the Congressional Budget Office (CBO) are within the mainstream of thinking among academics and private business economists. These projections do not attempt to anticipate cyclical movements, but instead represent estimates of the likely performance of the economy in the neighborhood of its potential. The Administration, for example, projected in its most recent forecast that the economy will expand at a 2.5 percent rate in the second half of the 1990s and unemployment will average 6.1 percent. These projections are consistent with common estimates of the economy's potential growth rate and fall within the range of typical estimates of the so-called "natural rate" of unemployment.

Uncertainties around these estimates arise because identifying economic relationships is always difficult, partly owing to limitations of the data. But more fundamentally, all policymakers recognize that notions of potential GDP growth and the natural rate of unemployment are considerable simplifications, useful in conceptual models but subject to a variety of real-world complications. Our economy is a complex, dynamic system, comprising countless and diverse households, firms, services, products, and prices, interacting in a multitude of markets. Estimates of macroeconomic relationships, as best we can make them, are useful starting points for analysis—but they are just starting points.

Given questions about the aggregate relationships, policymakers need to look below the surface, in markets themselves, for evidence of tightness that might indicate whether inflationary pressures are indeed building.

One important source of such evidence is the reports we receive from our Reserve Banks through their extensive contacts in their communities. These reports are released to the public in the "beige book" and are updated—frequently on the basis of confidential information from individual firms and financial institutions—by the Reserve Bank officials at our meetings and through normal intermeeting communications. Another source of useful information is individual industries and trade groups, which provide many timely indicators that are sensitive to supply–demand conditions in particular sectors.

If the economy were nearing capacity, we would expect to see certain patterns in the statistical and anecdotal information with increasing frequency and intensity. Reports of shortages of skilled labor, strikes, and instances of difficulties in finding workers in specific regions all would be more likely. To attract additional workers, employers would presumably step up their use of want-ads and might begin to use nonstandard techniques, such as signing or recruiting bonuses. More firms might choose to bring on less skilled workers and train them on the job. All of these steps in themselves could add to costs and suggest developing inflationary imbalances. As firms experienced difficulty in expanding production to meet rising demand, we would also expect to see increasingly frequent signs of shortages of goods as well as labor. Businesses might have difficulty in obtaining certain materials. Vendor performance would deteriorate, and lead times on deliveries of new orders would increase. Pressures on supplies of materials and commodities would be reflected in rising prices of these items.

Of course, we would not expect to see these phenomena occur simultaneously throughout the economy—quite the contrary. And, to a degree, these symptoms occur in a few sectors even in noninflationary economies. But a noticeable step-up in their incidence could constitute evidence of an incipient inflationary process.

In recent months, we have seen some of these signs. There are reports of shortages of some types of labor—construction workers and truck drivers, for instance. Indexes of vendor performance have deteriorated considerably, and manufacturers are paying higher prices for materials used in their production processes. As yet, these sorts of indications do not seem to be widespread across the economy. Nonetheless, we shall need to be particularly alert to these emerging signs in considering further adjustments to policy in the period ahead.

Financial flows may also impart useful warnings of price pressures. For example, persistent unsustainably low real interest rates might prompt very rapid credit growth, as expectations of price increases led households and firms to accelerate purchases of durable goods and equipment and finance these expenditures by stepping up the pace of borrowing. Although consumer borrowing has accelerated considerably of late, overall debt growth has so far remained moderate.

In light of the uncertainties about aggregate measures of our economic potential, the Federal Reserve cannot rely heavily on any one estimate of either the natural rate of unemployment or potential GDP growth. Most important, we have no intention of setting artificial limits on employment or growth. Indeed, the Federal Reserve would be pleased to see more rapid output growth and lower unemployment than projected by forecasters such as the CBO and the Administration—provided they were sustainable and consistent with approaching price stability. I should note, however, that most Federal Reserve policymakers would not regard the inflation projections of these other forecasters, which generally do not foresee further progress toward price stability over the medium term, as a desirable outcome.

A more significant issue for economic policymakers than the precise values of such estimates is what can be done to maximize sustainable employment and economic growth. We need, for example, to give careful attention to the problem of unemployment, as noted by the G-7 leaders at their recent summit. We could raise output and living standards around the world and at the same time ease many social problems if more people were working. Here at home, nearly eight million Americans are looking for work. At this stage of the business cycle—having experienced almost forty months of expansion and particularly strong growth recently—most of this unemployment probably is not due to a shortfall in aggregate demand. Rather, a good deal of it is likely "frictional," reflecting the ordinary process of workers moving between jobs, or "structural," resulting from longer-term mismatches between workers and available jobs. Monetary policy, which works mainly by influencing aggregate demand, is not suited to addressing such problems. But we ought to be encouraging other measures to increase the flexibility of our workforce and labor markets. Improving education and training and facilitating better and more rapid matching of workers with jobs are essential elements in making more effective use of the U.S. labor force.

Just as important, Congress should avoid enacting policies that create impediments to the efficient movement of individuals across regions, industries, and occupations, or that unduly discourage the hiring of those seeking work. Competitive markets have shown a remarkable ability to create rising standards of living when left free to function.

Congress and the Administration also can continue to contribute to the growth of our economy's capital and productivity through a sound fiscal policy. The extension of the spending caps in last year's budget agreement was a significant step in putting fiscal policy on a more sustainable long-run path. Budget deficit reduction has proved to be particularly timely, by reducing the government's claim on savings just as households and firms are seeking more capital to finance investments. But under current law, the deficit as a percent of GDP will begin to expand again as we move into the next century, with unacceptable consequences for financial stability and economic growth. The primary cause of this increase will be federal outlays, which will almost surely again be rising at a pace that will exceed the growth of our tax base. Only by reducing the growth in spending is ultimate balance achievable.

As I have emphasized many times, the Federal Reserve also can contribute to the achievement of our overriding goal—maximum sustainable economic growth—by pursuing and ultimately achieving a stable price level. Without the uncertainties engendered by inflation, households and firms are better able to plan for the future. And firms focus on maximizing profitability by holding down costs and increasing productivity rather than by using inflationary conditions to support price increases. There is some evidence to suggest that the stronger trend of productivity growth we have witnessed over the recent past is due at least partly to the beneficial effects of low rates of inflation.

Our nation has made considerable progress in putting the economy on a sound footing in the past few years. To preserve and extend these advances, our monetary and fiscal policies will need to remain disciplined and focused on our long-term objectives; we would be foolish to squander our recent gains for near-term benefits that would prove ephemeral. Indeed, by fostering progress toward price stability, achieving lower federal budget deficits, and encouraging competitive markets both here and abroad, we will help ensure the continued vitality of our nation's economy now and for many years into the future.

FRB1–46000–0794