1996 MONETARY POLICY OBJECTIVES

Summary Report of the Federal Reserve Board

July 18, 1996

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

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Contents

Testimony of Alan Greenspan
Chairman, Federal Reserve Board

Before I take this opportunity to discuss the performance of the U.S. economy and the conduct of monetary policy, I would first like to thank the Chairman and the other members of this Committee for their support during my confirmation process. I am grateful for the opportunity to serve the nation in this capacity for another term.

Review of the First Half of 1996

Nineteen-ninety-six has been a good year for the American economy. By all indications, spending and production were robust in the first half of this year. GDP increased at a 2¼ percent annual rate in the first quarter. Partial data suggest a significantly stronger increase in the second quarter as the economy, as expected, accelerated out of its soft patch around the turn of the year. During the second quarter, industrial production rose at an annual rate of 5½ percent, and manufacturers are currently running their plant and equipment at utilization rates that are a touch above their postwar averages. About 1.4 million workers have been added to nonfarm payrolls in the first six months of the year, and the unemployment rate fell to 5.3 percent in June.

Even though the U.S. economy is using its productive resources intensively, inflation has remained quiescent. The core inflation rate, measured by the consumer price index less food and energy prices, at a 2.8 percent annual rate over the first six months of the year, is about ½ percentage point slower than the same period one year ago. While increases in energy prices have boosted the overall CPI inflation rate to 3.5 percent thus far in 1996, a partial reversal of the jump in petroleum product prices observed in the first half appears to be in train. I shall be discussing in greater detail later some possible reasons for this favorable inflation experience and offering some thoughts about how long it might last.

Economic activity thus far this year has turned out to be better than many analysts expected. An important supporting factor, as I pointed out in February, was favorable conditions in financial markets in the latter part of 1995 and early 1996. Intermediate- and longer-term interest rates were low. Among the influences accounting for this were optimism about prospective budget-deficit reduction, small easings of the stance of monetary policy in the second half of 1995 and early 1996, and the possibility of a further moderation in credit demands owing to a potentially soft economy.

Credit remained readily available, with banks and other lenders in financial markets generally pursuing credit opportunities aggressively. And a rising stock market reduced the cost of capital to businesses and bolstered household balance sheets.

Looking forward, there are a number of reasons to expect demands to moderate and economic activity to settle back toward a more sustainable pace in the months ahead.

First, the bond markets have taken a turn toward restraint this year as they have responded to incoming data depicting an economy that was stronger than had been anticipated. Intermediate- and longer-term interest rates have risen from 1 to 1¼ percentage points since January.

Second, the value of the dollar on foreign exchange markets has appreciated significantly on a trade-weighted basis against the currencies of other industrial countries over the past year or so. This appreciation importantly reflects the market perception that the U.S. economy has been performing better than those of many of our major trading partners. The rise in the dollar helps to keep down price pressures, but it also tends to divert domestic demand toward imported goods and damp exports some.

Third, the support to economic growth provided by expenditures on durable goods, both for household consumption and business fixed investment, is likely to wane in coming quarters. Consumer spending in the past few years has been boosted as households have made up for the purchases of big-ticket items that they had deferred during the recession and the early, weaker phase of the recovery. Five years after the business-cycle trough, however, we should expect that this pent-up demand has been largely exhausted. Moreover, many households have built up sizable debt burdens in recent years, and coping with debt repayments could hold down their spending. The business sector has been adding considerably to capacity; opportunities to invest profitably in new capital should be increasing less rapidly as final demand slows some.

While these are all good reasons to anticipate that economic growth will moderate some, the timing and extent of that downshift are uncertain. We have not, as yet, seen much effect of the rise in interest rates on, for example, the housing market. In many other aspects, financial market conditions remain quite supportive to domestic spending, and the economies of many foreign countries are showing signs of achieving more solid growth, which should help support our export sales. Moreover, and perhaps of most relevance, a desire to build inventories could add significantly to production in the near term. Data available for 1996 through May show that inventories were reduced relative to sales and are now fairly lean in many important industries. Although the use of just-in-time inventory and production systems encourages purchasing managers to keep stocks lean, any evidence that deliveries of previously ordered goods are being delayed for extended periods would quickly alert companies to the need for higher safety stocks. Indeed, indications of some mounting delivery delays in June do raise warning flags in this regard. The reversal of earlier draw-downs in inventories, of course, could potentially impart an important boost to incomes and production as we enter the second half of the year. The economy is already producing at a high level—and some early signs of pressures on resources are emerging, especially in the labor market.

The Recent Behavior of Inflation

There are, to be sure, legitimate questions about how much margin in resource utilization currently exists. Historically, current levels of slack, measured in terms of either the unemployment rate or capacity utilization, have often been associated with a gradual strengthening of price and wage pressures. Yet, the recent evidence of such pressures is scant. I have already noted the lack of a distinct trend in the growth rate of the so-called core CPI. Increases in more comprehensive, and perhaps more representative, chain-weighted measures of consumer prices, based on the national income and product accounts, actually have continued to edge lower. The same is true of a still broader measure of price change, the chain-weighted price index for gross domestic purchases, which covers both consumers and businesses. Although nominal wage rates have accelerated recently, the rate of increase has been lagging significantly behind that predicted on the basis of historical relationships with unemployment and past inflation. And domestic profit margins have held up far later into this economic expansion than is the norm.

Have we moved into a new environment where inflation imbalances no longer threaten the stability and growth of our economy in ways they once did? The simple answer, in our judgment, is no. But the issue is not a simple one.

As we have discussed before, powerful forces have evolved in the past few years to help contain inflationary tendencies. An ever-increasing share of our nation's workforce uses the tools of new technologies. Microchips embodied in physical capital make it work more efficiently, and sophisticated software adds to intellectual capital.

The consequent waves of improvements in production techniques have quickly altered the economic viability of individual firms and sometimes even entire industries, as well as the market value of workers' skills. With such fast and changeable currents, it is not surprising that workers may be less willing to test the waters of job change. Indeed, voluntary job leaving to seek other employment appears to be quite subdued despite evidence of a tight labor market. Because workers are more worried about their own job security and their marketability if forced to change jobs, they are apparently accepting smaller increases in their compensation at any given level of labor market tightness. Moreover, a growing share of all output competes in an increasingly global marketplace, allowing fixed costs to be spread over ever broader markets, promoting greater specialization and efficiency, and enhancing price competition.

As I indicated in February, these forces, to the extent that they are operative, exert a transitory, not permanent, effect in reducing wage and price inflation. These trends leave the level of both wages and prices lower than historical relationships would predict. But, at some point, greater job security will no longer be worth the further sacrifice of gains in real wages. The growth of wages will then again be more responsive to tightness of labor markets, potentially putting pressure on profit margins and ultimately prices. Moreover, the reductions in unit costs that are a consequence of the ever expanding global reach of many companies must ultimately be bound by the limits of geography. To be sure, production and sales will continue to be diversified across geographic areas, but the world can only figuratively shrink so far. At some point, possibly well into the future, increasing returns from ever-greater globalization must also ebb.

Perhaps reflecting these unusual influences, we have yet to see early signs in prices themselves of intensifying pressures, despite anecdotal and statistical evidence that the amount of operating slack in our economy has been at low levels by historic standards for some time. Among the encouraging indicators, industrial commodity prices have remained roughly flat and the list of reported shortages of materials has been exceptionally small. This pattern is consistent with the view that American businesses, by and large, have felt comfortable that inflation has been subdued and offers little evidence of the advance buying and expanded commitments that would come if businesses were expecting significant price pressures in the reasonably near future.

Nonetheless, there are early indications that this episode of favorable inflation developments, especially with regard to labor markets, may be drawing to a close. The surprising strength in the employment cost index for wages and salaries in the first quarter raises the possibility that workers' willingness to surrender wage gains for job security may be lessening. Wage data since March have been somewhat difficult to read. Average hourly earnings clearly accelerated in the second quarter. However, in looking at those figures, one must be mindful that they can reflect not only changes in wage rates but also shifts in the composition of employment. And in recent months, a significant part, although not all of the pickup, has been accounted for by a tendency for employment to shift to relatively high-pay industries, such as durable goods manufacturing. Whether such shifts also imply a correspondingly higher level of output per worker will determine whether unit labor costs also accelerated to impart upward pressures to price inflation. Increases in pay, of course, are not inflationary so long as they are matched by gains in productivity. Without question, we would applaud such trends, which increase standards of living. However, wage gains that increase unit costs and are eaten up by inflation help no one, and ultimately place economic growth in jeopardy.

Clearly, in this environment, the Federal Reserve has had to become especially vigilant to incipient inflation pressures that could ultimately threaten the health of the expansion. The relatively good inflation performance of the past few years, as best we can judge, owes in part to transitional forces that are only temporarily damping the wage–price inflation process. We cannot be confident that we can ascertain when that process will come to an end. This makes policy responses more difficult than usual, because, as always, the impact of policy will be felt with a significant lag. Of course, if the economy grows so strongly as to strain available resources, transitional forces notwithstanding, history persuasively indicates that imbalances will develop that will bring the expansion to a halt.

The FOMC's Outlook for the Remainder of 1996 and 1997

The forecasts of the governors of the Federal Reserve Board and presidents of the Federal Reserve Banks for economic performance over the remainder of this year and the next reflect the view that sustainable economic growth is likely in store. The growth rate of real GDP is most commonly seen as between 2½ and 2¾ percent over the four quarters of 1996 and 1¾ to 2¼ percent in 1997. Given the strong performance of real GDP in the last two quarters, this outcome implies slower growth in the second half of this year.

Nonetheless, for the remainder of this year and the next in these projections, the unemployment rate remains in the range of the past 1½ years. Inflation, as measured by the four-quarter percent change in the consumer price index, is expected to be 3 to 3¼ percent in 1996. The governors and bank presidents, however, view the prospects for inflation to be more favorable going forward. The expected reversal of some of the recent run-up in energy prices would contribute to that result, but policy makers' forecasts also reflect their determination to hold the line on inflation. The central tendency of their inflation forecasts for 1997 is 2¾ to 3 percent, returning to the range from 1991 to 1995.

The Pursuit of Price Stability

We at the Federal Reserve would welcome faster economic growth, provided that it were sustainable. As I emphasized last February, we do not have firm judgments on the specific level or growth rate of output that would engender economic strains. Instead, we respond to evidence that those strains themselves are developing. Whatever the long-run potential for sustainable growth, we believe that a necessary condition for achieving it is low inflation. As a consequence, the Federal Reserve remains committed to preventing a sustained pickup in inflation and ultimately achieving and preserving price stability.

Price stability is an appropriate and desirable goal for policy, not only because it allows financial markets and the economy to work most efficiently, but also because it most likely raises productivity and living standards in the long run. Specifically, in an inflationary environment, business managers are distracted from their basic function of building profits through prudent investment and cost control. My own observation of business practices over the years suggests that the inability to pass cost increases through to higher prices provides a powerful incentive to firms to increase profit margins through innovation and greater efficiency, which boosts productivity and ultimately standards of living over time. Holding the line on inflation, thus, does not impose a speed limit on economic growth. On the contrary, it induces the private sector to focus more on efforts that yield faster long-term economic growth.

In this context, we can readily understand why financial markets welcome sustained low inflation. Uncertainty about future inflation raises the risks associated with investing for that future. Lowering that uncertainty by keeping inflation down diminishes those risks, so that all commitments concerning future income become more valuable.

During periods of low inflation, stock and bond prices tend to reflect the higher valuation that comes from harnessing our physical plant more efficiently to provide improved opportunities in the future, including higher wages and profits. What investors fear, what all Americans should fear, are inflationary instabilities. They diminish our ability to provide the wherewithal for the standards of living of the next generation and the retirement incomes of our current work force. The interests of investors as expressed in bond and stock markets do not conflict with those of average Americans—they coincide.

In order to realize the benefits of low and declining inflation, Federal Reserve policy has, for some time now, been designed to act preemptively—as I indicated earlier—to look beyond current data readings and base action on its assessment of where the economy is headed. Policy restraint initiated in February 1994 followed from the judgment that unchanged policy would encourage subsequent inflationary imbalances that would ultimately cut short the economic expansion. The three easing steps in the past year were instituted when we anticipated that inflationary imbalances would be less threatening and that lower rates would be compatible with promoting sustainable economic expansion.

Similarly, I am confident that the Federal Open Market Committee would move to tighten reserve market conditions should the weight of incoming evidence persuasively suggest an oncoming intensification of inflation pressures that would jeopardize the durability of the economic expansion.

The Ranges for the Debt and Monetary Aggregates

The Committee selected provisional ranges for the monetary aggregates in 1997 that once again encompass the growth rates associated with conditions of approximate price stability, provided that these aggregates act in accord with their historical relationships with nominal income and interest rates. These ranges are identical to those endorsed for 1996—1 to 5 percent for M2 and 2 to 6 percent for M3. The Committee reaffirmed its range of 3 to 7 percent for the debt of the domestic nonfinancial sectors for this year and chose the same range provisionally for next year. The Committee's expectations for inflation and nominal GDP expansion in 1996 and 1997 suggest growth of the monetary aggregates at the upper ends of their benchmark ranges as a distinct possibility this year and next, though debt should be in the middle portion of its range.

The experience of the first part of the 1990s—when money growth diverged from historical relationships with income and interest rates—severely set back most analysts' confidence in the usefulness of M2. Recently, there have been tentative signs that the historical relationship linking the velocity of M2—or the ratio of nominal GDP to the money stock—to the cost of holding M2 assets has reasserted itself. For now, though, the Committee is satisfied with watching these developments carefully, waiting for more compelling evidence that M2 has some predictive content in forecasting current and prospective spending. Such evidence, however, at best will only accumulate gradually over time.

Budgetary Policy

Monetary policy is, of course, only one factor shaping the macroeconomic environment. I thus would be remiss if I did not again emphasize the critical importance to our nation's economic welfare of continuing to reduce our federal budget deficit. We have made significant and welcome progress on this score in recent years. But unless further legislative steps are taken, that progress will be reversed. Inevitably, such changes will require addressing the consequences for entitlement spending of the anticipated shift in the nation's demographics in the first few decades of the next century. Lower budget deficits are the surest and most direct way to increase national saving. Higher national saving would help to lower real interest rates, spurring spending on capital goods so as to put cutting-edge technology in the hands of more American workers. With a greater volume of modern equipment at their disposal, American workers will be able to produce goods that compete even more effectively on world markets.

The rally in capital markets last year that trimmed as much as two percentage points from longer-term Treasury yields was almost surely, in part, a response to the developing positive dialogue on deficit reduction. While the backup in intermediate- and longer-term market interest rates this year has mostly reflected the unexpected vigor of economic activity, market participants must also have been struck by the dying out of serious discussions that might lead to a bipartisan agreement to eliminate the budget deficit over time.

Conclusion

Mr. Chairman, our economy is now in its sixth year of economic expansion. The staying power of the expansion has owed importantly to the initial small size and rapid correction of emerging imbalances, reflected in part in the persistence of low inflation.

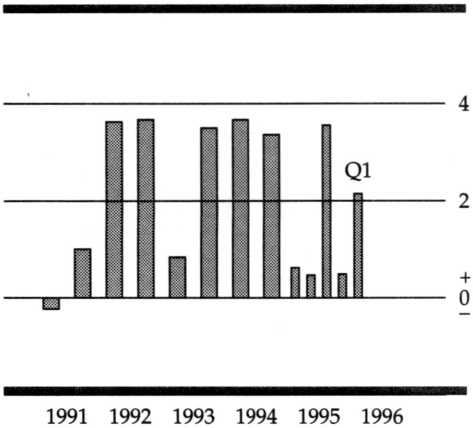
To be sure, the economy is not free of problems. But as we address those problems, policy makers also need to recognize the limitations of our influence and the wellspring of our success. The good performance of the American economy in the most fundamental sense rests on the actions of millions of people, who have been given the scope to express themselves in free and open markets. In this, we are a model for the rest of the world, which has come to appreciate the power of market economies to provide for the public's long-term welfare.

Monetary Policy and the Economic Outlook

The U.S. economy performed well in the first half of 1996. In early February, when the Federal Reserve prepared its last report on monetary policy, there was some concern about the strength and durability of the current economic expansion: The economy was operating at a relatively high level of resource utilization, but it was not exhibiting a great deal of forward momentum. As the year has unfolded, however, economic activity has proven quite robust. After rising only fractionally in the fourth quarter of 1995, real gross domestic product posted a solid gain over the first half of 1996, providing a considerable lift to job growth. Looking ahead, the members of the Federal Open Market Committee (FOMC) anticipate that economic activity will grow more moderately, on average, in coming quarters and that the unemployment rate will remain around the level it has averaged over the past year and a half.

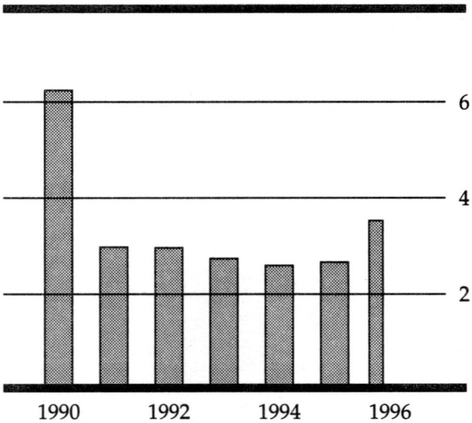
Change in Real GDP

Percent, annual rate



Change in Consumer Prices

Percent, Dec. to Dec.



Note. Consumer price index for all urban consumers. Value for 1996 is measured from December 1995 to June 1996, at an annual rate.

Although overall consumer price inflation was boosted by higher energy prices during the first half of the year, the underlying trend of prices still appears to have been well contained. Over the past twelve months, the consumer price index excluding food and energy items has risen 2¾ percent—near the lower end of the narrow range that has prevailed since early 1994. Moreover, the deflator for personal consumption expenditures on items other than food and energy derived from data reported in the national income and product accounts has continued to show a slowing trend.

The combination of brisk growth and favorable underlying inflation so far this year has, of course, been welcome. Nonetheless, mounting pressures on resources are apparent in some segments of the economy—most notably in the labor market—and these pressures must be monitored closely. Allowing inflationary forces to intensify would ultimately disrupt the growth process. The Federal Reserve recognizes that its contribution to promoting the optimal performance of the economy involves containing the rate of inflation and, over time, moving toward price stability.

Economic Projections for 1996 and 1997

As noted previously, 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 think it likely that economic activity will return to a moderate growth path in the second half of 1996 and in 1997 after the larger gains in the first half of this year. For 1996 as a whole, this would result in an increase in real gross domestic product in the range of 2½ to 2¾ percent, somewhat above the forecasts in the February report on monetary policy. For 1997, the central tendency of the forecasts spans a range of 1¾ to 2¼ percent. The civilian unemployment rate, which averaged around 5½ percent in the second quarter of 1996, is expected to stay near this level through the end of this year and perhaps to edge higher during 1997.

Economic activity clearly retains considerable momentum. The trend in final demand is positive, and inventories appear to be well aligned with the current pace of sales—perhaps even a bit lean. Accordingly, the members of the FOMC recognize the possibility that growth could remain elevated a while, with the potential for putting greater pressure on resources. Nonetheless, most members think that some slowing from the rapid growth pace recorded, on average, in the first half is the most likely outcome. Housing construction and other interest-sensitive activity should be restrained to some degree by the rise in long-term interest rates over the past several months. And, although some of the lagging economies abroad are expected to perform better this year, there are still concerns about the solidity of that acceleration and the associated lift to U.S. exports. In addition, growth in real business fixed investment appears to be tapering off, although spending will likely remain buoyant, owing to the rapid rate of product innovation and dramatic price declines in the computer area.

Economic Projections for 1996 and 1997
Percent

		Federal Reserve Governors and Reserve Bank Presidents		Administration
1996		Range	Central Tendency	
Change, fourth quarter to fourth quarter:[1]	Nominal GDP	4¾ to 5¾	5 to 5½	5.0
	Real GDP	2½ to 3	2½ to 2¾	2.6
	Consumer price index[2]	3 to 3¼	3 to 3¼	3.2
Average level in the fourth quarter:	Civilian unemployment rate	5¼ to 5¾	About 5½	5.6
1997		Range	Central Tendency	
Change, fourth quarter to fourth quarter:[1]	Nominal GDP	4 to 5½	4¼ to 5	5.1
	Real GDP	1½ to 2½	1¾ to 2¼	2.3
	Consumer price index[2]	2½ to 3¼	2¾ to 3	2.8
Average level in the fourth quarter:	Civilian unemployment rate	5½ to 6	5½ to 5¾	5.7

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

2. All urban consumers.

Consumer spending is also expected to grow less rapidly in coming quarters. Household wealth has been boosted substantially by the runup in stock prices over the past year and a half, but, for many households, debt burdens have risen significantly in recent years and may represent a constraint on purchases of big-ticket items.

Most members of the FOMC expect the rise in the consumer price index over the four quarters of 1996 to be in the range of 3 to 3¼ percent, about ¼ percentage point higher than they predicted last winter. The projected increase in the CPI is also somewhat larger than that recorded in 1995. However, that stepup would mainly reflect developments in the food and energy sectors, which are likely to add to overall inflation in 1996 after having damped it in 1995. Apart from these volatile sectors, inflation has remained in check so far this year despite high levels of resource utilization and reports that tightness in some parts of the labor market is placing upward pressure on wages. Assuming no further adverse shocks to food and energy prices, and in the context of the Federal Reserve's intent to keep trend inflation well contained, the Committee believes that overall CPI inflation should recede. Accordingly, the central tendency of the FOMC's forecasts shows CPI inflation dropping back to the range of 2¾ to 3 percent in 1997.

The Committee's inflation projections incorporate the technical improvements the Bureau of Labor Statistics is making to the CPI in 1996 and 1997; they are expected to shave a little from inflation in both years. The Committee also recognizes that the remaining biases in the CPI are non-negligible and may not be stable over time. Thus, it will continue to monitor a variety of alternative measures of price change as it attempts to gauge progress toward the long-run goal of price stability.

The Administration has just released its midyear update to its economic and budgetary projections. Its forecasts for real growth and inflation in 1996 and 1997 are broadly in line with the central tendencies of the forecasts of Federal Reserve policymakers.

Money and Debt Ranges for 1996 and 1997

At its meeting earlier this month, the Committee reaffirmed the ranges for 1996 growth of money and debt that it had established in February:
1 percent to 5 percent for M2,
2 percent to 6 percent for M3, and
3 percent to 7 percent for the debt of the domestic nonfinancial sectors.

Ranges for Growth of Monetary and Debt Aggregates
Percent

Aggregate	1995	1996	Provisional for 1997
M2	1–5	1–5	1–5
M3	2–6	2–6	2–6
Debt[1]	3–7	3–7	3–7

Note. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.

1. Monitoring range for debt of domestic nonfinancial sectors.

In addition, the Committee set provisional growth ranges for 1997 at the same levels.

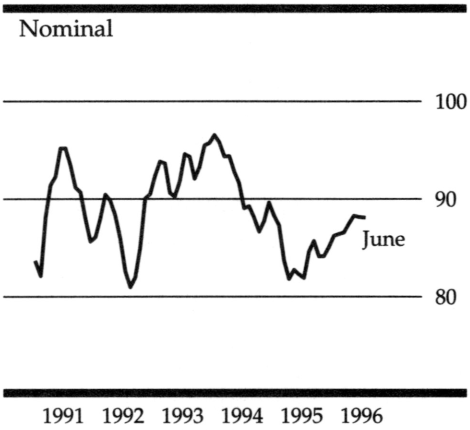
In setting the ranges for M2 and M3, the Committee intended to communicate its expectation as to the growth of these monetary aggregates that would result under conditions of approximate price stability, assuming that the aggregates exhibit the same trends relative to nominal spending that prevailed for many years until the early 1990s and that seem to have reemerged after an intervening period of marked deviation. Based on that reemergence and on Committee members' expectations for the growth of nominal GDP in 1996 and 1997, the Committee anticipates that both M2 and M3 will probably finish near the upper boundaries of their respective ranges each year. The Committee expects the debt of the domestic nonfinancial sectors to remain near the middle of its monitoring range in 1996 and 1997. In light of the rapid pace of technological change and innovation still occurring in the financial sector—and the attending uncertainty about the future behavior of the aggregates—the Committee will continue to rely on a wide range of other information in determining its policy stance.

Monetary Policy, Financial Markets, and the Economy over the First Half of 1996

Information available around the turn of the year suggested that the economy had downshifted after posting a strong gain in the third quarter of 1995. The growth of final demand appeared to have slowed, reflecting importantly a deceleration of consumer spending. In addition, hesitant growth abroad and a strengthening in the foreign exchange value of the dollar relative to the levels prevailing at mid-1995 were seen as limiting the prospects for further growth in exports. The slowdown in the growth of final demand had given rise to inventory buildups in some industries;

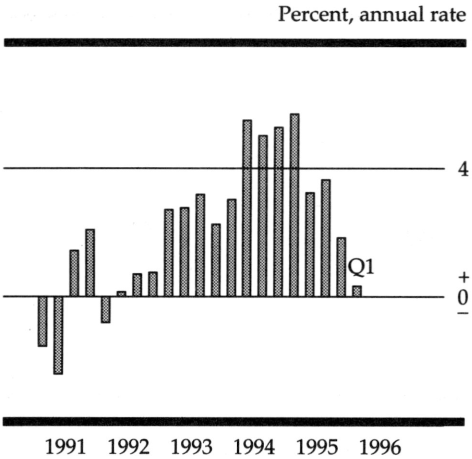
Exchange Value of the U.S. Dollar

Index, March 1973 = 100



Note. In terms of the currencies of the other G-10 countries. Weights are based on 1972–76 global trade of each of the ten countries.

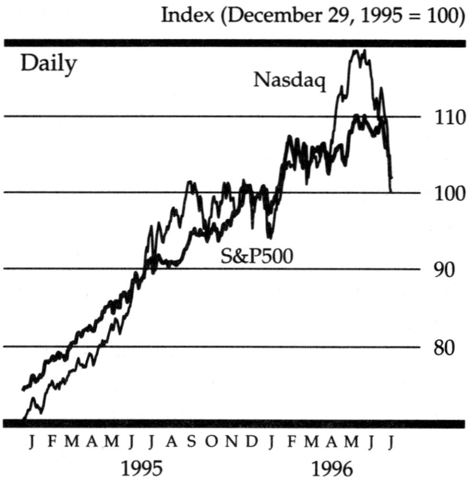
Change in Real Nonfarm Business Inventories



in turn, the production cutbacks undertaken in response to those buildups were having a further damping effect on economic activity.Meanwhile, data on prices and wages suggested that inflation performance continued to be fairly satisfactory—indeed, better than many members of the FOMC had expected as of midyear 1995. To keep the stance of monetary policy from becoming effectively more restrictive owing to the slowdown in inflation in the second half of last year, and to promote sustainable growth, the Committee eased the stance of policy in December 1995 and again at the end of January 1996, bringing the federal funds rate down a half percentage point in total, to 5¼ percent.

Most participants in financial markets were unsurprised by these policy adjustments, given the economic backdrop. Moreover, they anticipated that there would be scope for additional easing steps in the coming months. Thus, between mid-December and the end of January, interest rates on Treasury securities generally moved lower, especially at short and intermediate maturities, and stock price indexes edged higher on balance. The dollar strengthened slightly on net against the currencies of the other G-10 countries, reflecting in part disappointing news about the pace of activity in Europe and consequently larger declines in interest rates there than in the United States.

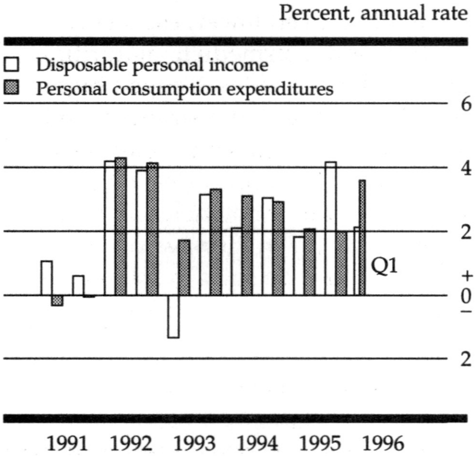
Major Stock Price Indexes



Note. Last observations are for July 16, 1996.

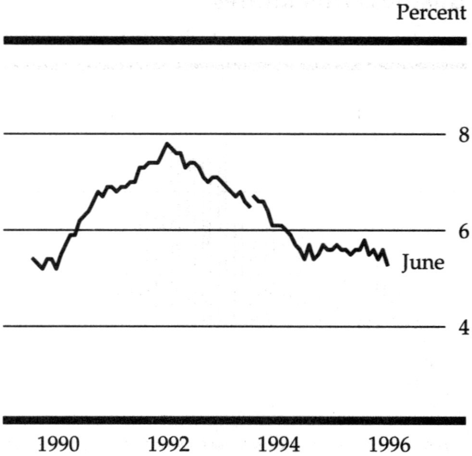
The underlying trends in the economy early in the year were obscured to a degree by extraordinarily adverse weather that affected a significant part of the country.

Change in Real Income and Consumption



Through the course of the next few months, however, it became increasingly clear that the economy had regained vitality. Consumer spending perked up after a lackluster holiday season, and was only temporarily depressed by the severe winter. Business demand for equipment proved quite strong, as did housing demand. The strengthening in sales facilitated businesses' efforts to control their inventories, and as that situation improved, industrial production rebounded smartly. Overall employment growth was brisk, and by June the unemployment rate reached its lowest level in six years.

Civilian Unemployment Rate

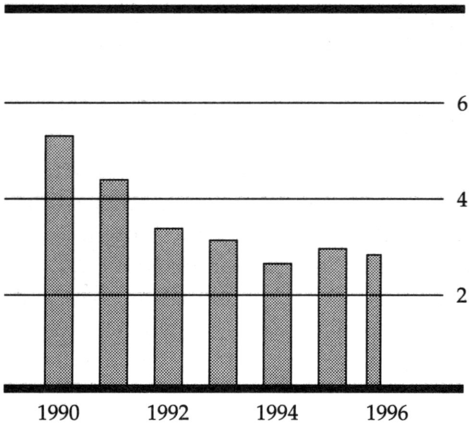


Note. The break in data at January 1994 marks the introduction of a redesigned survey; data from that point on are not directly comparable with the data of earlier periods.

Inflation during the first half of the year was generally well behaved. Energy prices surged, mainly in response to a runup in the world price of oil, and bad news about grain crops raised the prospect of higher food prices down the road. However, price inflation for consumer items other than food and energy held steady or moved a bit lower. Labor costs presented a mixed picture. The increase in total hourly compensation over the first three months of the year, as measured by the employment cost index, was in line with its recent moderate trend. However, within total compensation, the wage and salary component of the ECI surged in the first quarter,

Change in Consumer Prices Excluding Food and Energy

Percent, Dec. to Dec.

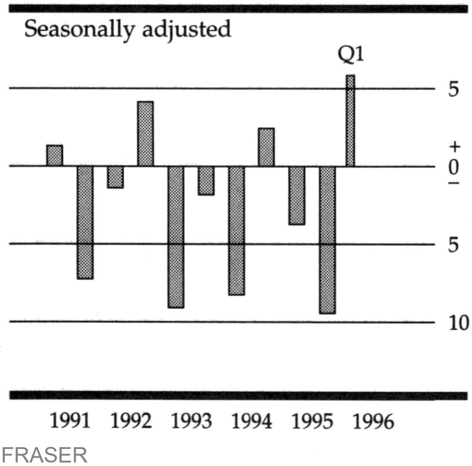


Note. Consumer price index for all urban consumers. Value for 1996 is measured from December 1995 to June 1996, at an annual rate.

and further signals of wage acceleration came from a more rapid increase in average hourly earnings in the second quarter.

Change in Real Federal Expenditures on Consumption and Investment

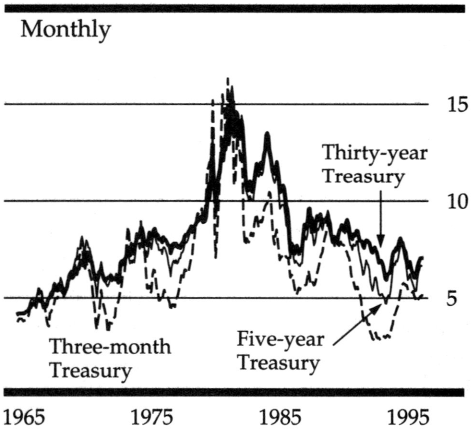
Percent, annual rate



Against the backdrop of stronger activity but subdued inflation trends, the Federal Reserve made no adjustments to its policy stance after January. With economic activity more clearly on the upswing, however, and prospects for a breakthrough on the federal budget seeming to fade, intermediate- and long-term interest rates reversed course in February and trended up over subsequent months. Since the end of December, the yield on the 30-year Treasury bond has increased about 1 percentage point,

Selected Treasury Rates

Percent



Note. The twenty-year Treasury bond rate is shown until the first issuance of the thirty-year Treasury bond in February 1977.

on net, while the yield on the 5-year note has risen about 1¼ percentage points over the same period. The rate on three-month bills has edged up only slightly.

Despite the backup in bond yields, major stock-price indexes rose considerably further through the first half of the year; most of those gains were erased in late June and the first half of July, however, as company reports raised questions about the pace of earnings growth. The rise in bond yields has boosted the dollar in foreign exchange markets; since mid-April, the dollar has generally traded against an average of the currencies of the other major industrial countries about 4 percent above its level at the end of December.

During the first half of the year, credit remained easily available to most household and business applicants. Interest-rate spreads on private debt over Treasury securities remained narrow. In response to the recent increase in delinquencies on credit-card accounts, many banks have tightened their standards for approval of new accounts, but this appears to have only partially reversed a marked relaxation of such standards earlier this decade, and banks overall remain aggressive in the pursuit of new borrowers, especially business clients. The debt of all domestic nonfinancial sectors combined expanded at about a 4¾ percent annual pace, placing this aggregate near the middle of its monitoring range. M2 and M3 are currently near the 5 and 6 percent upper boundaries of their respective growth ranges, in line with the FOMC's expectation as of last February. In contrast to the experience of the early 1990s, growth in the monetary aggregates relative to nominal GDP has been broadly in line with historical relationships, given the structure of interest rates.

Growth of Money and Debt
Percent

Period		M1	M2	M3	Domestic Nonfinancial Debt
Annual[1]	1980	7.5	8.7	9.6	9.5
	1981	5.4 (2.5)[2]	9.0	12.4	10.2
	1982	8.8	8.8	9.7	9.8
	1983	10.3	11.8	9.5	11.9
	1984	5.4	8.1	10.8	14.6
	1985	12.0	8.6	7.7	14.4
	1986	15.5	9.2	9.0	13.3
	1987	6.3	4.2	5.9	10.0
	1988	4.3	5.7	6.3	8.8
	1989	0.6	5.2	4.0	7.9
	1990	4.1	4.1	1.8	6.8
	1991	7.9	3.1	1.2	4.6
	1992	14.3	1.8	0.6	4.7
	1993	10.5	1.4	1.0	5.2
	1994	2.4	0.6	1.6	5.2
	1995	–1.8	4.0	5.9	5.6
1995 Quarter *(annual rate)*[3]	Q1	–0.1	1.0	4.5	5.4
	Q2	–0.5	3.8	6.3	7.1
	Q3	–1.5	6.9	7.9	4.9
	Q4	–5.1	4.1	4.5	4.7
1996 Quarter *(annual rate)*[3]	Q1	–2.7	5.9	7.2	4.7
	Q2	–0.5	4.1	5.3	n.a.

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.
2. Adjusted for shifts to NOW accounts in 1981.
3. From average for preceding quarter to average for quarter indicated.

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