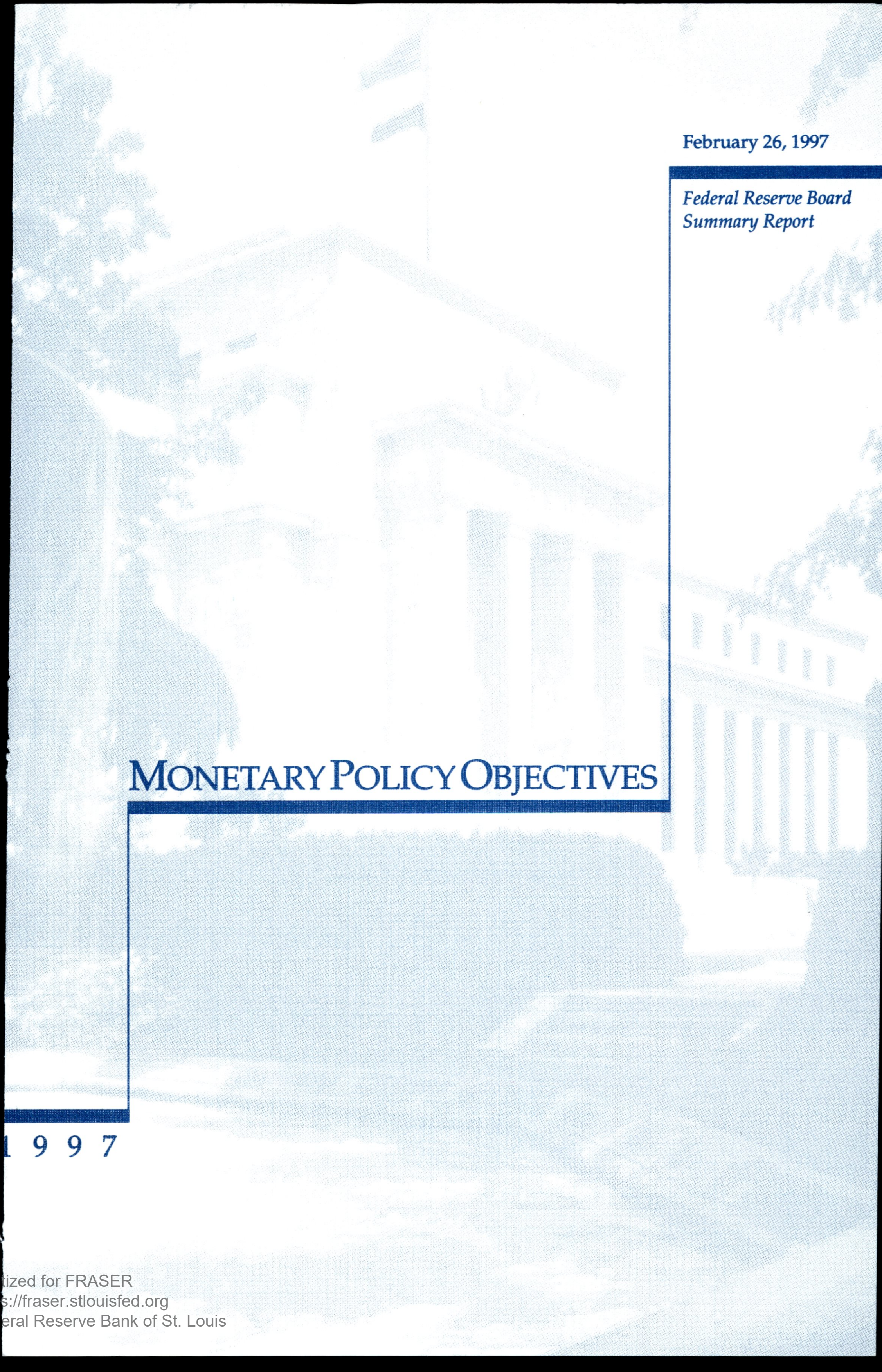

February 26, 1997

Federal Reserve Board
Summary Report

MONETARY POLICY OBJECTIVES

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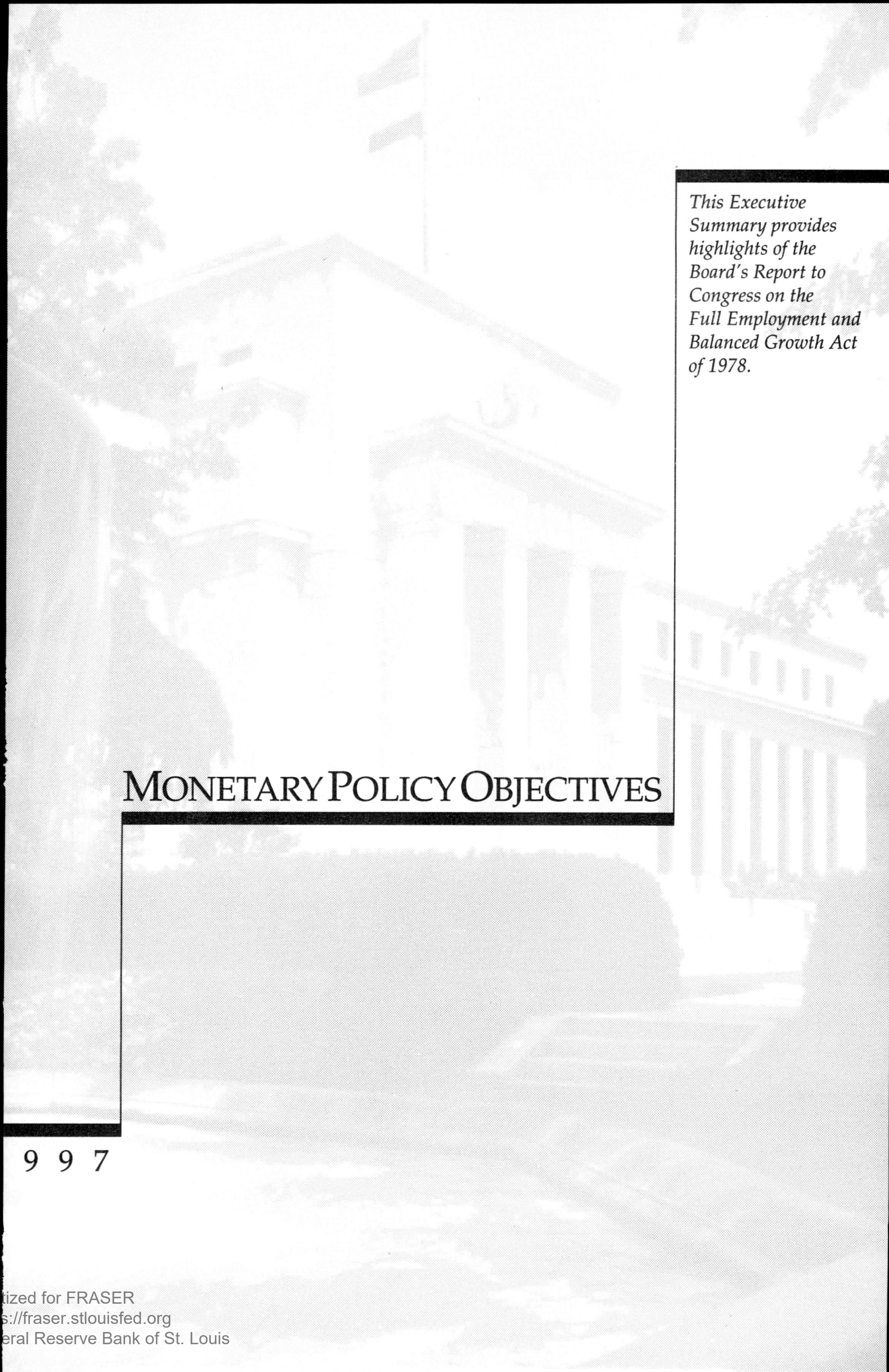

This Executive Summary provides highlights of the Board's Report to Congress on the Full Employment and Balanced Growth Act of 1978.

MONETARY POLICY OBJECTIVES

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Contents

Testimony of Alan Greenspan Chairman, Federal Reserve Board

I appreciate the opportunity to appear before this Committee to present the Federal Reserve's semiannual report on monetary policy.

The performance of the U.S. economy over the past year has been quite favorable. Real GDP growth picked up to more than three percent over the four quarters of 1996, as the economy progressed through its sixth year of expansion. Employers added more than two-and-a-half million workers to their payrolls in 1996, and the unemployment rate fell further. Nominal wages and salaries have increased faster than prices, meaning workers have gained ground in real terms, reflecting the benefits of rising productivity. Outside the food and energy sectors, increases in consumer prices actually have continued to edge lower, with core CPI inflation only 2½ percent over the past twelve months.

Low inflation last year was both a symptom and a cause of the good economy. It was symptomatic of the balance and solidity of the expansion and the evident absence of major strains on resources. At the same time, continued low levels of inflation and inflation expectations have been a key support for healthy economic performance. They have helped to create a financial and economic environment conducive to strong capital spending and longer-range planning generally, and so to sustained economic expansion. Consequently, the Federal Open Market Committee (FOMC) believes it is crucial to keep inflation contained in the near term and ultimately to move toward price stability.

Looking ahead, the members of the FOMC expect inflation to remain low and the economy to grow appreciably further. However, as I shall be discussing, the unusually good inflation performance of recent years seems to owe in large part to some temporary factors, of uncertain longevity. Thus, the FOMC continues to see the distribution of inflation risks skewed to the upside and must remain especially alert to the possible emergence of imbalances in financial and product markets that ultimately could endanger the maintenance of the low-inflation environment. Sustainable economic expansion for 1997 and beyond depends on it.

For some, the benign inflation outcome of 1996 might be considered surprising, as resource utilization rates—particularly of labor—were in the neighborhood of those that historically have been associated with building inflation pressures.

To be sure, an acceleration in nominal labor compensation, especially its wage component, became evident over the past year. But the rate of pay increase still was markedly less than historical relationships with labor market conditions would have predicted. Atypical restraint on compensation increases has been evident for a few years now and appears to be mainly the consequence of greater worker insecurity. In 1991, at the bottom of the recession, a survey of workers at large firms by International Survey Research Corporation indicated that 25 percent feared being laid off. In 1996, despite the sharply lower unemployment rate and the tighter labor market, the same survey organization found that 46 percent were fearful of a job layoff.

The reluctance of workers to leave their jobs to seek other employment as the labor market tightened has provided further evidence of such concern, as has the tendency toward longer labor union contracts. For many decades, contracts rarely exceeded three years. Today, one can point to five- and six-year contracts—contracts that are commonly characterized by an emphasis on job security and that involve only modest wage increases. The low level of work stoppages of recent years also attests to concern about job security.

Thus, the willingness of workers in recent years to trade off smaller increases in wages for greater job security seems to be reasonably well documented. The unanswered question is why this insecurity persisted even as the labor market, by all objective measures, tightened considerably. One possibility may lie in the rapid evolution of technologies in use in the work place. Technological change almost surely has been an important impetus behind corporate restructuring and downsizing. Also, it contributes to the concern of workers that their job skills may become inadequate. No longer can one expect to obtain all of one's lifetime job skills with a high-school or college diploma. Indeed, continuing education is perceived to be increasingly necessary to retain a job. The more pressing need to update job skills is doubtless also a factor in the marked expansion of on-the-job training programs, especially in technical areas, in many of the nation's corporations.

Certainly, other factors have contributed to the softness in compensation growth in the past few years. The sharp deceleration in health care costs, of course, is cited frequently. Another is the heightened pressure on firms and their workers in industries that compete internationally. Domestic deregulation has had similar effects on the intensity of competitive forces in some industries.

In any event, although I do not doubt that all these factors are relevant, I would be surprised if they were nearly as important as job insecurity.

If heightened job insecurity is the most significant explanation of the break with the past in recent years, then it is important to recognize that, as I indicated in last February's Humphrey–Hawkins testimony, suppressed wage cost growth as a consequence of job insecurity can be carried only so far. At some point, the tradeoff of subdued wage growth for job security has to come to an end. In other words, the relatively modest wage gains we have experienced are a temporary rather than a lasting phenomenon because there is a limit to the value of additional job security people are willing to acquire in exchange for lesser increases in living standards. Even if real wages were to remain permanently on a lower upward track than otherwise as a result of the greater sense of insecurity, the rate of change of wages would revert at some point to a normal relationship with inflation. The unknown is when this transition period will end.

Indeed, some recent evidence suggests that the labor markets bear especially careful watching for signs that the return to more normal patterns may be in process. The Bureau of Labor Statistics reports that people were somewhat more willing to quit their jobs to seek other employment in January than previously. The possibility that this reflects greater confidence by workers accords with a recent further rise in the percent of households responding to a Conference Board survey who perceive that job availability is plentiful. Of course, the job market has continued to be quite good recently; employment in January registered robust growth and initial claims for unemployment insurance have been at a relatively low level of late. Wages rose faster in 1996 than in 1995 by most measures, perhaps also raising questions about whether the transitional period of unusually slow wage gains may be drawing to a close.

To be sure, the pickup in wage gains has not shown through to underlying price inflation. Increases in the core CPI, as well as in several broader measures of prices, have stayed subdued or even edged off further in recent months. As best we can judge, faster productivity growth last year meant that rising compensation gains did not cause labor costs per unit of output to increase any more rapidly. Non-labor costs, which are roughly a quarter of total consolidated costs of the nonfinancial corporate sector, were little changed in 1996.

Owing in part to this subdued behavior of unit costs, profits and rates of return on capital have risen to high levels. As a consequence, businesses believe that, were they to raise prices to boost profits further, competitors with already ample profit margins would not follow suit;

instead, they would use the occasion to capture a greater market share. This interplay is doubtless a significant factor in the evident loss of pricing power in American business.

Intensifying global competition also may be further restraining domestic firms' ability to hike prices as well as wages. Clearly, the appreciation of the dollar on balance over the past eighteen months or so, together with low inflation in many of our trading partners, has resulted in a marked decline in non-oil import prices that has helped to damp domestic inflation pressures. Yet it is important to emphasize that these influences, too, would be holding down inflation only temporarily; they represent a transition to a lower price level than would otherwise prevail, not to a permanently lower rate of inflation.

Against the background of all these considerations, the FOMC has recognized the need to remain vigilant for signs of potentially inflationary imbalances that might, if not corrected promptly, undermine our economic expansion. The FOMC in fact has signaled a state of heightened alert for possible policy tightening since last July in its policy directives. But, we have also taken care not to act prematurely. The FOMC refrained from changing policy last summer, despite expectations of a near-term policy firming by many financial market participants. In light of the developments I've just discussed affecting wages and prices, we thought inflation might well remain damped, and in any case was unlikely to pick up very rapidly, in part because the economic expansion appeared likely to slow to a more sustainable pace. In the event, inflation has remained quiescent since then.

Given the lags with which monetary policy affects the economy, however, we cannot rule out a situation in which a preemptive policy tightening may become appropriate before any sign of actual higher inflation becomes evident. If the FOMC were to implement such an action, it would be judging that the risks to the economic expansion of waiting longer had increased unduly and had begun to outweigh the advantages of waiting for uncertainties to be reduced by the accumulation of more information about economic trends. Indeed, the hallmark of a successful policy to foster sustainable economic growth is that inflation does not rise. I find it ironic that our actions in 1994–95 were criticized by some because inflation did not turn upward. That outcome, of course, was the intent of the tightening, and I am satisfied that our actions then were both necessary and effective, and helped to foster the continued economic expansion.

To be sure, 1997 is not 1994. The real federal funds rate today is significantly higher than it was three years ago. Then we had just completed an extended period of monetary ease which addressed the credit stringencies of the early 1990s, and with the abatement of the credit crunch, the low real funds rate of early 1994 was clearly incompatible with containing inflation and sustaining growth going forward. In February 1997, in contrast, our concern is a matter of relative risks rather than of expected outcomes. The real funds rate, judging by core inflation, is only slightly below its early 1995 peak for this cycle and might be at a level that will promote continued non-inflationary growth, especially considering the recent rise in the exchange value of the dollar. Nonetheless, we cannot be sure. And the risks of being wrong are clearly tilted to the upside.

I wish it were possible to lay out in advance exactly what conditions have to prevail to portend a buildup of inflation pressures or inflationary psychology. However, the circumstances that have been associated with increasing inflation in the past have not followed a single pattern. The processes have differed from cycle to cycle, and what may have been a useful leading indicator in one instance has given off misleading signals in another.

I have already discussed the key role of labor market developments in restraining inflation in the current cycle and our careful monitoring of signs that the transition phase of trading off lower real wages for greater job security might be coming to a close. As always, with resource utilization rates high, we would need to watch closely a situation in which demand was clearly unsustainable because it was producing escalating pressures on resources, which could destabilize the economy. And we would need to be watchful that the progress we have made in keeping inflation expectations damped was not eroding. In general, though, our analysis will need to encompass all potentially relevant information, from financial markets as well as the economy, especially when some signals, like those in the labor market, have not been following their established patterns.

The ongoing economic expansion to date has reinforced our conviction about the importance of low inflation—and the public's confidence in continued low inflation. The economic expansion almost surely would not have lasted nearly so long had monetary policy supported an unsustainable acceleration of spending that induced a buildup of inflationary imbalances. The Federal Reserve must not acquiesce in an upcreep in inflation, for acceding to higher inflation would countenance an insidious weakening of our chances for sustaining long-run economic growth. Inflation interferes with the efficient allocation of resources by confusing price signals, undercutting a focus on the longer run, and distorting incentives.

This year overall inflation is anticipated to stay restrained. The central tendency of the forecasts made by the Board members and Reserve Bank presidents has the increase in the total CPI slipping back into a range of 2¾ to 3 percent over the four quarters of the year. This slight falloff from last year's pace is expected to owe in part to a slower rise in food prices as some of last year's supply limitations ease. More importantly, world oil supplies are projected by most analysts to increase relative to world oil demand, and futures markets project a further decline in prices, at least in the near term. The recent and prospective declines in crude oil prices not only should affect retail gasoline and home heating oil prices but also should relieve inflation pressures through lower prices for other petroleum products, which are imbedded in the economy's underlying cost structure. Nonetheless, the trend in inflation rates in the core CPI and in broader price measures may be somewhat less favorable than in recent years. A continued tight labor market, whose influence on costs would be augmented by the scheduled increase in the minimum wage later in the year and perhaps by higher growth of benefits now that considerable health-care savings already have been realized, could put upward pressure on core inflation. Moreover, the effects of the sharp rise in the dollar over the last eighteen months in pushing down import prices are likely to ebb over coming quarters.

The unemployment rate, according to Board members and Bank presidents, should stay around 5¼ to 5½ percent through the fourth quarter, consistent with their projections of measured real GDP growth of 2 to 2¼ percent over the four quarters of the year. Such a growth rate would represent some downshifting in output expansion from that of last year. The projected moderation of growth likely would reflect several influences: (1) declines in real federal government purchases should be exerting a modest degree of restraint on overall demand; (2) the lagged effects of the increase in the exchange value of the dollar in recent months likely will damp U.S. net exports somewhat this year; and (3) residential construction is unlikely to repeat the gains of 1996. On the other hand, we do not see evidence of widespread imbalances either in business inventories or in stocks of equipment and consumer durables that would lead to a substantial cutback in spending. And financial conditions overall remain supportive; real interest rates are not high by historical standards and credit is readily available from intermediaries and in the market.

The usual uncertainties in the overall outlook are especially focused on the behavior of consumers. Consumption should rise roughly in line with the projected moderate expansion of disposable income, but both upside and downside risks are present.

According to various surveys, sentiment is decidedly upbeat. Consumers have enjoyed healthy gains in their real incomes along with the extraordinary stock-market driven rise in their financial wealth over the last couple of years. Indeed, econometric models suggest that the more than $4 trillion rise in equity values since late 1994 should have had a larger positive influence on consumer spending than seems to have actually occurred.

It is possible, however, that households have been reluctant to spend much of their added wealth because they see a greater need to keep it to support spending in retirement. Many households have expressed heightened concern about their financial security in old age, which reportedly has led to increased provision for retirement. The results of a survey conducted annually by the Roper Organization, which asks individuals about their confidence in the Social Security system, shows that between 1992 and 1996 the percent of respondents expressing little or no confidence in the system jumped from about 45 percent to more than 60 percent.

Moreover, consumer debt burdens are near historical highs, while credit card delinquencies and personal bankruptcies have risen sharply over the past year. These circumstances may make both borrowers and lenders a bit more cautious, damping spending.

In fact, we may be seeing both wealth and debt effects already at work for different segments of the population, to an approximately offsetting extent. Saving out of current income by households in the upper income quintile, who own nearly three-fourths of all non-pension equities held by households, evidently has declined in recent years. At the same time, the use of credit for purchases appears to have leveled off after a sharp runup from 1993 to 1996, perhaps because some households are becoming debt constrained and, as a result, are curtailing their spending.

The Federal Reserve will be weighing these influences as it endeavors to help extend the current period of sustained growth. Participants in financial markets seem to believe that in the current benign environment the FOMC will succeed indefinitely. There is no evidence, however, that the business cycle has been repealed. Another recession will doubtless occur some day owing to circumstances that could not be, or at least were not, perceived by policymakers and financial market participants alike. History demonstrates that participants in financial markets are susceptible to waves of optimism, which can in turn foster a general process of asset–price inflation that can feed through into markets for goods and services. Excessive optimism sows the seeds of its own reversal in the form of imbalances that tend to grow over time.

When unwarranted expectations ultimately are not realized, the unwinding of these financial excesses can act to amplify a downturn in economic activity, much as they can amplify the upswing. As you know, last December I put the question this way: ". . . how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions . . .?"

We have not been able, as yet, to provide a satisfying answer to this question, but there are reasons in the current environment to keep this question on the table. Clearly, when people are exposed to long periods of relative economic tranquility, they seem inevitably prone to complacency about the future. This is understandable. We have had fifteen years of economic expansion interrupted by only one recession—and that was six years ago. As the memory of such past events fades, it naturally seems ever less sensible to keep up one's guard against an adverse event in the future. Thus, it should come as no surprise that, after such a long period of balanced expansion, risk premiums for advancing funds to businesses in virtually all financial markets have declined to near-record lows.

Is it possible that there is something fundamentally new about this current period that would warrant such complacency? Yes, it is possible. Markets may have become more efficient, competition is more global, and information technology has doubtless enhanced the stability of business operations. But, regrettably, history is strewn with visions of such "new eras" that, in the end, have proven to be a mirage. In short, history counsels caution.

Such caution seems especially warranted with regard to the sharp rise in equity prices during the past two years. These gains have obviously raised questions of sustainability. Analytically, current stock-price valuations at prevailing long-term interest rates could be justified by very strong earnings growth expectations. In fact, the long-term earnings projections of financial analysts have been marked up noticeably over the last year and seem to imply very high earnings growth and continued rising profit margins, at a time when such margins are already up appreciably from their depressed levels of five years ago. It could be argued that, although margins are the highest in a generation, they are still below those that prevailed in the 1960s. Nonetheless, further increases in these margins would evidently require continued restraint on costs: labor compensation continuing to grow at its current pace and productivity growth picking up. Neither, of course, can be ruled out. But we should keep in mind that, at these relatively low long-term interest rates, small changes in long-term earnings expectations could have outsized impacts on equity prices.

Caution also seems warranted by the narrow yield spreads that suggest perceptions of low risk, possibly unrealistically low risk. Considerable optimism about the ability of businesses to sustain this current healthy financial condition seems, as I indicated earlier, to be influencing the setting of risk premiums, not just in the stock market but throughout the financial system. This optimistic attitude has become especially evident in quality spreads on high-yield corporate bonds—what we used to call "junk bonds." In addition, banks have continued to ease terms and standards on business loans, and margins on many of these loans are now quite thin. Many banks are pulling back a little from consumer credit card lending as losses exceed expectations. Nonetheless, some bank and nonbank lenders have been expanding aggressively into the home equity loan market and so-called "subprime" auto lending, although recent problems in the latter may already be introducing a sense of caution.

Why should the central bank be concerned about the possibility that financial markets may be overestimating returns or mispricing risk? It is not that we have a firm view that equity prices are necessarily excessive right now or risk spreads patently too low. Our goal is to contribute as best we can to the highest possible growth of income and wealth over time, and we would be pleased if the favorable economic environment projected in markets actually comes to pass. Rather, the FOMC has to be sensitive to indications of even slowly building imbalances, whatever their source, that, by fostering the emergence of inflation pressures, would ultimately threaten healthy economic expansion.

Unfortunately, because the monetary aggregates were subject to an episode of aberrant behavioral patterns in the early 1990s, they are likely to be of only limited help in making this judgment. For three decades starting in the early 1960s, the public's demand for the broader monetary aggregates, especially M2, was reasonably predictable. In the intermediate term, M2 velocity—nominal income divided by the stock of M2—tended to vary directly with the difference between money market yields and the return on M2 assets—that is, with its short-term opportunity cost. In the long run, as adjustments in deposit rates caused the opportunity cost to revert to an equilibrium, M2 velocity also tended to return to an associated stable equilibrium level. For several years in the early 1990s, however, the velocities of M2 and M3 exhibited persisting upward shifts that departed markedly from these historical patterns.

In the last two to three years, velocity patterns seem to have returned to those historical relationships, after allowing for a presumed permanent upward shift in the levels of velocity. Even so, given the abnormal velocity behavior during the early 1990s, FOMC members continue to see considerable uncertainty in the relationship of broad money to opportunity costs and nominal income. Concern about the possibility of aberrant behavior has made the FOMC hesitant to upgrade the role of these measures in monetary policy.

Against this background, at its February meeting, the FOMC reaffirmed the provisional ranges set last July for money and debt growth this year: 1 to 5 percent for M2, 2 to 6 percent for M3, and 3 to 7 percent for the debt of domestic nonfinancial sectors. The M2 and M3 ranges again are designed to be consistent with the FOMC's long-run goal of price stability: For, if the velocities of the broader monetary aggregates were to continue behaving as they did before 1990, then money growth around the middle portions of the ranges would be consistent with noninflationary, sustainable economic expansion. But, even with such velocity behavior this year, when inflation is expected to still be higher than is consistent with our long-run objective of reasonable price stability, the broader aggregates could well grow around the upper bounds of these ranges. The debt aggregate probably will expand around the middle of its range this year.

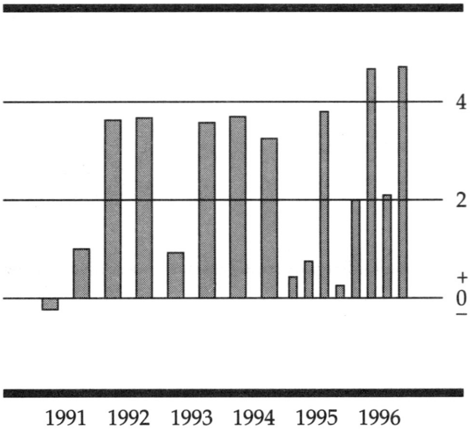
I will conclude on the same upbeat note about the U.S. economy with which I began. Although a central banker's occupational responsibility is to stay on the lookout for trouble, even I must admit that our economic prospects in general are quite favorable. The flexibility of our market system and the vibrancy of our private sector remain examples for the whole world to emulate. The Federal Reserve will endeavor to do its part by continuing to foster a monetary framework under which our citizens can prosper to the fullest possible extent.

Monetary Policy and the Economic Outlook

The economy performed impressively this past year, and members of the Board of Governors and Reserve Bank presidents anticipate that 1997 will bring further appreciable economic expansion with relatively low inflation. In 1996, solid advances in the real expenditures of households and businesses led to sizable gains in output. Employment rose briskly, and the unemployment rate edged down to its lowest level of the current expansion. Consumer price inflation increased owing to the likely temporary effects of firmness in food and energy markets, but some broader price measures showed inflation holding steady or even declining. With the economy strengthening, intermediate- and long-term interest rates rose on net, but credit continued to be amply available to businesses and most households, and equity prices soared.

Change in Real GDP

Percent, annual rate

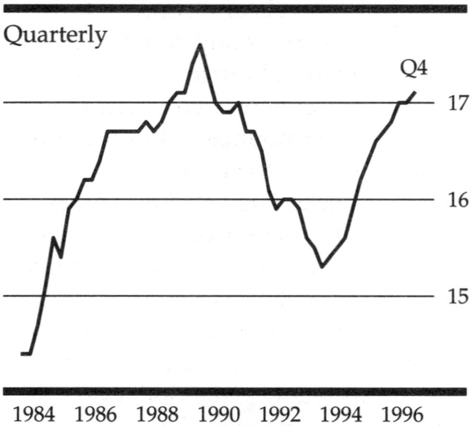


Several factors helped to restrain price increases this past year in the face of high levels of resource utilization. With workers still concerned to some degree about job security, acceleration in hourly compensation was not so pronounced as in comparable periods in the past; wage increases picked up relatively moderately, and further success in controlling health care costs helped to temper the rise in benefits. Moreover, significant declines in the prices of U.S. imports, owing to low inflation abroad and appreciation of the dollar on foreign exchange markets, tended to hold down domestic prices. Damped inflation expectations probably contributed as well to the favorable price performance: A lengthening run of years during which inflation has been in a more moderate range, together with an understanding of the Federal Reserve's commitment to maintaining progress toward price stability, may have discouraged aggressive pricing behavior. Business firms continued to rely on cost control and gains in productivity, rather than on price increases, as the primary channels for achieving profit growth.

Still, the Federal Open Market Committee (FOMC) recognized the danger that pressures emanating from the tight labor market might trigger an acceleration of prices, which could eventually undermine the ongoing economic expansion.

Household Debt Service Burden

Percent of disposable personal income



Note. Debt service is the sum of required interest and principal payments on consumer and household-sector mortgage debt.

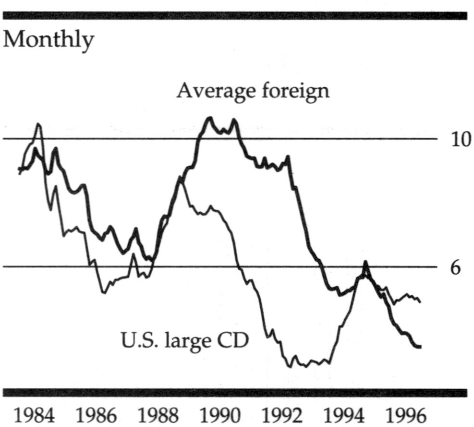
Consequently, although conditions last year were not deemed to warrant immediate policy action, the Committee's policy directives starting in mid-1996 reflected a perception that the most likely direction of any policy action would be toward greater restraint in the provision of reserves to the banking system. Forestalling a disruptive buildup of inflationary pressures in the near term and moving toward price stability over time remain central to the System's mission of promoting maximum sustainable growth of employment and production.

Monetary Policy, Financial Markets, and the Economy in 1996

The FOMC eased the stance of monetary policy twice around the beginning of last year—in December 1995 and in January—lowering the federal funds rate ½ percentage point in total, to 5¼ percent. These actions were taken to offset the effect on the level of the real federal funds rate of declines in inflation and inflation expectations in the second half of 1995 and thereby to help ensure the resumption of moderate economic growth after the marked slowdown and inventory correction in late 1995. By the spring, economic growth had become more vigorous than either the Committee or financial markets had foreseen.

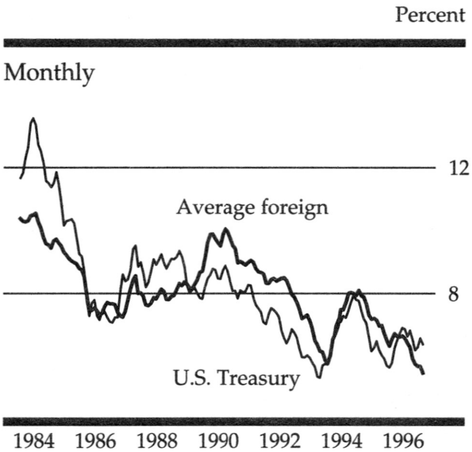
Three-month Interest Rates

Percent



Note. Average foreign rates are the global trade-weighted average, for the other G-10 countries, of yields on instruments comparable to U.S. instruments shown.

Ten-year Interest Rates

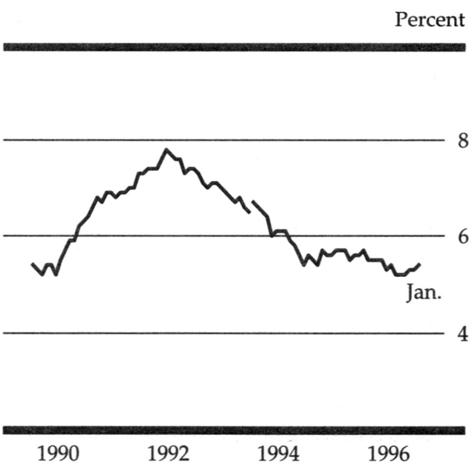


Note. Average foreign rates are the global trade-weighted average, for the other G-10 countries, of yields on instruments comparable to U.S. instruments shown.

In response, intermediate- and longer-term interest rates as of mid-May were up around a full percentage point from the two-year lows reached early in the year.In combination with some softening of economic activity abroad and declines in interest rates in major foreign industrial countries, these developments contributed to a further appreciation of the dollar, building on the rise that had started in mid-1995. The Committee anticipated that the increase in the cost of credit, along with the higher exchange value of the dollar, would be sufficient to foster a downshift in economic expansion to a more sustainable pace and contain price pressures; thus, it left its policy stance unchanged at its spring meetings.

By early summer, however, the continued momentum in demand and pressures on labor resources that were being reflected in faster growth in wages were seen as posing a threat of increased inflation. Core inflation remained moderate, but in light of the heightened risk that it would turn upward, the Committee in its early July directive to the Manager of the Open Market Account indicated its view that near-term economic developments were more likely to lead to a tightening of policy than to an easing. Labor markets continued to be taut over the balance of the year, and this bias toward restraint was included in directives adopted at all of the Committee's remaining meetings in 1996.

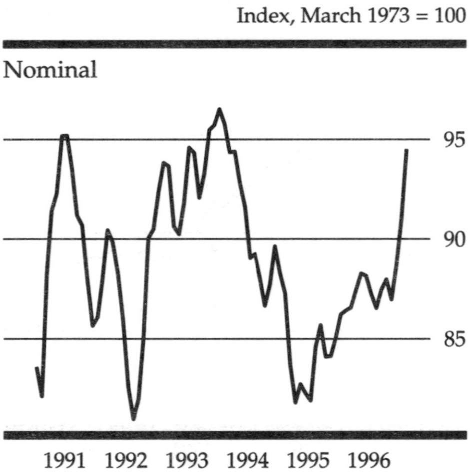
Civilian Unemployment Rate



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.

After peaking during mid-summer, interest rates moved down on balance through the fall, as expansion of consumer spending and economic activity in general appeared to be moderating and markets saw less likelihood of a need for Federal Reserve firming action. Equity prices fell back for a time during the summer, reversing some of the substantial increase registered over the first half of the year, but by autumn they had reached new highs. Interest rates and dollar exchange rates turned back up late in the year when signs of rapid growth and more intense use of the economy's resources reemerged. Since year-end, interest rates have changed little, on net.

Weighted Average Exchange Value of the U.S. Dollar

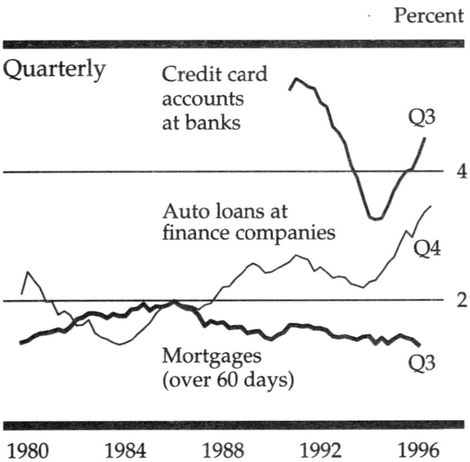


Note. In terms of the currencies of the other G-10 countries. Weights are based on 1972–76 global trade of each of the ten countries.

The foreign exchange value of the dollar has posted further gains, in part reflecting greater-than-expected weakness in Europe and renewed pessimism about economic and financial prospects in Japan. Equity prices have registered new highs since the start of the year. As of mid-February, intermediate- and long-term interest rates were up about ½ to ¾ percentage point, on balance, since early 1996, and the value of the dollar was up around 9 percent against an average of other G-10 currencies.

For the nonfinancial business sector, the effect of the higher intermediate- and long-term interest rates on the overall cost of funds last year was offset to some degree by an easing of lending terms at banks and a narrowing of yield spreads on corporate bonds over Treasuries, as well as by declines in the cost of capital in the equity market. Encouraged, perhaps, by the prospects of sustained economic expansion and low inflation, banks, market lenders, and equity investors displayed a strong appetite for business obligations and seemed willing to require less compensation for the possible risks entailed. Some households, by contrast, faced a tightening of standards and terms with respect to credit card debt and some other types of consumer debt last year, as banks reacted to a rising volume of delinquencies and charge-offs on these instruments.

Delinquency Rates on Household Loans



However, credit availability under home equity lines increased, particularly from finance companies but also from banks. Overall debt growth slowed slightly but remained near the midpoint of its 3 percent to 7 percent monitoring range.The growth rates of M2 and M3 edged up last year and, as was anticipated in the monetary policy reports to the Congress last February and July, both aggregates ended 1996 near or above the upper end of their growth ranges. Again last year, the growth of M2 relative to nominal income and interest rates was generally in line with historical relationships, in contrast to its behavior during the early years of the decade.

Economic Projections for 1997

With the economy free of serious imbalances, prospects appear favorable for further growth of activity and expansion of job opportunities in the coming year, although resource constraints seem likely to keep the pace of growth below that of 1996. The central tendency of the GDP growth forecasts put forth by members of the Board of Governors and the Reserve Bank presidents is from 2 percent to 2¼ percent, measured as the change in real output between the final quarter of 1996 and the final quarter of 1997. Output growth of this magnitude is expected to result in little change in the civilian unemployment rate, which is projected to be between 5¼ percent and 5½ percent in the fourth quarter of this year. These forecasts of GDP growth and unemployment are similar to those of the Administration. The central tendency of the policymakers' CPI forecasts for 1997 spans the relatively narrow interval of 2¾ percent to 3 percent, with the lower bound near the inflation forecast of the Administration.

Consumer spending, which accounts for about two-thirds of total GDP, should be supported in coming quarters by further gains in income and the substantial increase in household net worth that has occurred over the past two years;

Economic Projections for 1997

Percent

Indicator		Federal Reserve governors and Reserve Bank presidents: Range	Federal Reserve governors and Reserve Bank presidents: Central tendency	Administration
Change, fourth quarter to fourth quarter:[1]	Nominal GDP	4¼–5¼	4½–4¾	4.6
	Real GDP[2]	2–2½	2–2¼	2.0
	Consumer price index[3]	2¾–3½	2¾–3	2.6
Average level, fourth quarter:	Civilian unemployment rate	5¼–5½	5¼–5½	5.4

1. Change from average for fourth quarter of 1996 to average for fourth quarter of 1997.

2. Chain-weighted.

3. All urban consumers.

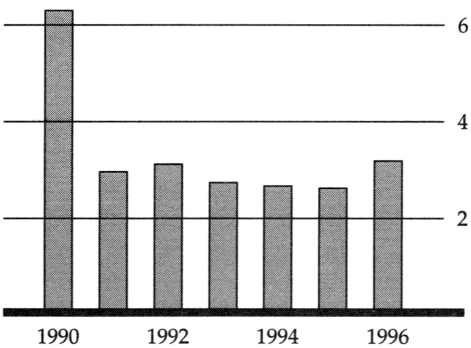
debt problems, although rising of late, do not seem to be so widespread as to threaten the ongoing expansion of household expenditures in the aggregate. In the business sector, balance sheets are strong, profits have been rising, and efforts to bolster efficiency through the use of technologically advanced equipment are continuing at an intense pace. In the commercial real estate market, the supply–demand balance has shifted in many locales to a point at which interest in office building projects has picked up noticeably. These conditions, together with the ready access to a wide variety of sources of finance that businesses currently are enjoying, should keep investment spending on an upward trajectory.

Foreign demand for U.S. products should continue to rise with growth of the world economy, even in the wake of the significant appreciation of the dollar since the first half of 1995; however, imports also seem likely to remain on a clear upward trend, given the prospects for continued expansion of the U.S. economy. Government expenditures for consumption and investment probably will follow recent trends, with further cutbacks in real outlays at the federal level and moderate increases in the combined purchases of state and local governments.

Although the risk of increased inflation pressures is significant, especially in view of the tightness of the labor market and the strength in activity that has been evident recently,

Change in Consumer Prices

Percent, Q4 to Q4



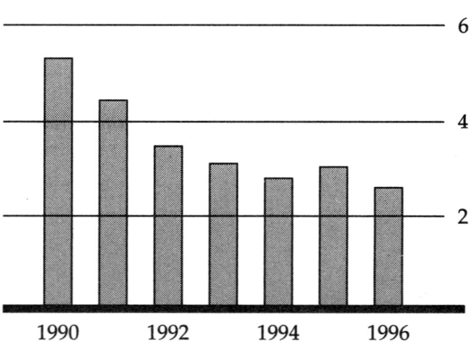
Note. Consumer price index for all urban consumers.

Federal Reserve policymakers expect this year's rise in the consumer price index to be somewhat smaller than that of 1996. The major reason for expecting a smaller CPI increase this year is a more favorable outlook for food and energy prices. Prices of farm products have dropped back from the highs of last summer, and, barring further weather problems, this year's rise in food prices at retail should be considerably smaller than that of 1996. Oil prices have recently declined and seem likely to ease further in coming months as world production and consumption come back into better balance; this price relief is important not only because of the direct effects on the price of gasoline and other consumer energy items but also because petroleum is a major element in the cost of producing and distributing many other goods.

By contrast to the favorable outlook for food and energy prices, some risk exists that core inflation could turn up during the coming year. The minimum wage will be moving up further in 1997, compounding whatever cost pressures might be in train as a result of labor market tightness, and the degree to which businesses can continue to absorb stepped-up increases in labor costs without raising prices more rapidly is not certain.

Change in Consumer Prices Excluding Food and Energy

Percent, Q4 to Q4



Note. Consumer price index for all urban consumers.

As noted in the July 1996 monetary policy report, the CPI forecasts of the governors and Reserve Bank presidents incorporate allowances for the technical improvements to this index that have been made by the Bureau of Labor Statistics.

These technical changes are estimated to have trimmed the reported rate of CPI inflation slightly in each of the past two years, and additional changes will be affecting the rise in the index in 1997. In view of the remaining difficulties of accurately measuring price change in a highly complex and rapidly changing economy, alternative price indexes will continue to be given substantial weight, along with the CPI, in monitoring progress toward the long-run goal of price stability. Some of the broad measures of inflation derived from the GDP accounts slowed in 1996; the Committee is concerned that, even if the CPI decelerates as expected in 1997, other indexes—with different scope and weights—may pick up in reflection of the pressures on productive resources.

Money and Debt Ranges for 1997

Again in 1997, the Committee has set ranges for M2 and M3 that would encompass monetary growth expected to be consistent with approximate price stability and a sustainable rate of real economic growth, assuming that the behavior of velocity is in line with historical norms. These ranges are unchanged from those for 1996: 1 to 5 percent for M2 and 2 to 6 percent for M3.

As has been the case for several years, the 1997 ranges for M2 and M3 were set against a backdrop of uncertainty about the stability and predictability of their velocities. A long-run pattern of reasonably stable velocity behavior broke down in the early 1990s when the public's holdings of monetary assets were depressed by several factors: the contraction of the thrift industry; a tightening of credit supplies and deleveraging by businesses and households; an extremely wide spread between short- and intermediate-term interest rates that heightened the attractiveness of capital market instruments relative to bank deposits; and the expanding availability and growing acceptance of stock and bond mutual funds as household investments.

Ranges for Growth of Monetary and Debt Aggregates

Percent

Aggregate	1995	1996	1997
M2	1–5	1–5	1–5
M3	2–6	2–6	2–6
Debt	3–7	3–7	3–7

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

With the waning of all but the last of these influences, movements in velocity have become more predictable over the past couple of years. This recent evidence of stability, however, covers only a relatively brief period, and its durability remains uncertain.

In these circumstances, the Committee has opted to continue treating the ranges as benchmarks for the trends of money growth consistent with price stability rather than as short-run targets for policy. Meanwhile, the actual behavior of the monetary measures will be monitored for such information as it may convey about underlying economic developments.

The central tendency of the Committee's expectations for nominal GDP growth in 1997 is slightly below that registered in 1996. Thus, if velocity behaves as it did last year, M2 and M3 might decelerate a bit but even so would again expand around the upper ends of their growth ranges. Debt of the nonfinancial sectors is anticipated to increase this year at around the pace of last year, remaining near the midpoint of its unchanged 3 to 7 percent range.

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