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1998 Monetary Policy Objectives

A Summary Report of the Federal Reserve Board

1998 MONETARY POLICY OBJECTIVES

This Executive Summary provides highlights of the Board's Report to Congress on the Full Employment and Balanced Growth Act of 1998

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Testimony of Alan Greenspan Chairman, Federal Reserve Board

Mr. Chairman and members of the Committee, I welcome this opportunity to present the Federal Reserve's semiannual report on economic conditions and the conduct of monetary policy.

The U.S. Economy in 1997

The U.S. economy delivered another exemplary performance in 1997. Over the four quarters of last year, real GDP expanded close to 4 percent, its fastest annual increase in ten years. To produce that higher output, about 3 million Americans joined the nation's payrolls, in the process contributing to a reduction in the unemployment rate to 4¾ percent, its lowest sustained level since the late 1960s. And our factories were working more intensively too: Industrial production increased 5¾ percent last year, exceeding robust additions to capacity.

Those gains were shared widely. The hourly wage and salary structure rose about 4 percent, fueling impressive increases in personal incomes. Unlike some prior episodes when faster wage rate increases mainly reflected attempts to make up for more rapidly rising prices of goods and services, the fatter paychecks that workers brought home represented real increments to purchasing power. Measured consumer price inflation came in at 1¾ percent over the twelve months of 1997, down about 1½ percentage points from the pace of the prior year. While swings in the prices of food and fuel contributed to this decline, both narrower price indexes excluding those items and broader ones including all goods and services produced in the United States also paint a portrait of continued progress toward price stability. Businesses, for the most part, were able to pay these higher real wages while still increasing their earnings. Although aggregate data on profits for all of 1997 are not yet available, corporate profit margins most likely remained in an elevated range not seen consistently since the 1960s. These healthy gains in earnings and the expectations of more to come provided important support to the equity market, with most major stock price indexes gaining more than 20 percent over the year.

The strong growth of the real income of workers and corporations is not unrelated to the economy's continued good performance on inflation. Taken together, recent evidence supports the view that such low inflation, as closely approaching price stability as we have known in the United States in three decades, engenders many benefits. When changes in the general price level are small and predictable, households and firms can plan more securely for the future. The perception of reduced risk encourages investment. Low inflation also exerts a discipline on costs, fostering efforts to enhance productivity. Productivity is the ultimate source of rising standards of living, and we witnessed a notable pickup in this measure in the past two years.

The robust economy has facilitated the efforts of the Congress and the Administration to restore balance in the unified federal budget. As I have indicated to the Congress on numerous occasions, moving beyond this point and putting the budget in significant surplus would be the surest and most direct way of increasing national saving. In turn, higher national saving, by promoting lower real long-term interest rates, helps spur spending to outfit American firms and their workers with the modern equipment they need to compete successfully on world markets. We have seen a partial down payment of the benefits of better budget balance already: It seems reasonable to assume that the decline in longer-term Treasury yields last year owed, in part, to reduced competition—current and prospective—from the federal government for scarce private saving. However, additional effort remains to be exerted to address the effects on federal entitlement spending of the looming shift within the next decade in the nation's retirement demographics.

As I noted earlier, our nation has been experiencing a higher growth rate of productivity—output per hour worked—in recent years. The dramatic improvements in computing power and communication and information technology appear to have been a major force behind this beneficial trend. Those innovations, together with fierce competitive pressures in our high-tech industries to make them available to as many homes, offices, stores, and shop floors as possible, have produced double-digit annual reductions in prices of capital goods embodying new technologies. Indeed, many products considered to be at the cutting edge of technology as recently as two to three years ago have become so standardized and inexpensive that they have achieved near "commodity" status, a development that has allowed businesses to accelerate their accumulation of more and better capital.

Critical to this process has been the rapidly increasing efficiency of our financial markets—itself a product of the new technologies and of significant market deregulation over the years. Capital now flows with relatively little friction to projects embodying new ideas. Silicon Valley is a tribute both to American ingenuity and to the financial system's ever-increasing ability to supply venture capital to the entrepreneurs who are such a dynamic force in our economy.

With new high-tech tools, American businesses have shaved transportation costs, managed their production and use of inventories more efficiently, and broadened market opportunities.

The threat of rising costs in tight labor markets has imparted a substantial impetus to efforts to take advantage of possible efficiencies. In my Humphrey–Hawkins testimony last July, I discussed the likelihood that the sharp acceleration in capital investment in advanced technologies beginning in 1993 reflected synergies of new ideas, embodied in increasingly inexpensive new equipment, that have elevated expected returns and have broadened investment opportunities.

More recent evidence remains consistent with the view that this capital spending has contributed to a noticeable pickup in productivity—and probably by more than can be explained by usual business cycle forces. For one, the combination of continued low inflation and stable to rising domestic profit margins implies quite subdued growth in total consolidated unit business costs. With labor costs constituting more than two-thirds of those costs and labor compensation per hour accelerating, productivity must be growing faster, and that stepup must be roughly in line with the increase in compensation growth. For another, our more direct observations on output per hour roughly tend to confirm that productivity has picked up significantly in recent years, although how much the ongoing trend of productivity has risen remains an open question.

The acceleration in productivity, however, has been exceeded by the strengthening of demand for goods and services. As a consequence, employers had to expand payrolls at a pace well in excess of the growth of the working age population that profess a desire for a job, including new immigrants. As I pointed out last year in testimony before the Congress, that gap has been accommodated by declines in both the officially unemployed and those not actively seeking work but desirous of working. The number of people in those two categories decreased at a rate of about one million per year on average over the last four years. By December 1997, the sum had declined to a seasonally adjusted 10½ million, or 6 percent of the working age population, the lowest ratio since detailed information on this series first became available in 1970. Anecdotal information from surveys of our twelve Reserve Banks attests to our ever tightening labor markets.

Rapidly rising demand for labor has had enormous beneficial effects on our work force. Previously low- or unskilled workers have been drawn into the job market and have obtained training and experience that will help them even if they later change jobs. Large numbers of underemployed have been moved up the career ladder to match their underlying skills, and many welfare recipients have been added to payrolls as well, to the benefit of their long-term job prospects.

The recent acceleration of wages likely has owed in part to the ever-tightening labor market and in part to rising productivity growth, which, through competition, induces firms to grant higher wages. It is difficult at this time, however, to disentangle the relative contributions of these factors. What is clear is that, unless demand growth softens or productivity growth accelerates even more, we will gradually run out of new workers who can be profitably employed. It is not possible to tell how many more of the 6 percent of the working-age population who want to work but do not have jobs can be added to payrolls. A significant number are so-called frictionally unemployed, as they have left one job but not yet chosen to accept another. Still others have chosen to work in only a limited geographic area where their skills may not be needed.

Should demand for new workers continue to exceed new supply, we would expect wage gains increasingly to exceed productivity growth, squeezing profit margins and eventually leading to a pickup in inflation. Were a substantial pickup in inflation to occur, it could, by stunting economic growth, reverse much of the remarkable labor market progress of recent years. I will be discussing our assessment of these and other possibilities and their bearing on the outlook for 1998 shortly.

Monetary Policy in 1997

History teaches us that monetary policy has been its most effective when it has been preemptive. The lagging relationship between the Federal Reserve's policy instrument and spending, and, even further removed, inflation, implies that if policy actions are delayed until prices begin to pick up, they will be too late to fend off at least some persistent price acceleration and attendant economic instabilities. Preemptive policymaking is keyed to judging how widespread are emerging inflationary forces, and when, and to what degree, those forces will be reflected in actual inflation. For most of last year, the evident strains on resources were sufficiently severe to steer the Federal Open Market Committee (FOMC) toward being more inclined to tighten than to ease monetary policy. Indeed, in March, when it became apparent that strains on resources seemed to be intensifying, the FOMC imposed modest incremental restraint, raising its intended federal funds rate ¼ percentage point, to 5½ percent.

We did not increase the federal funds rate again during the summer and fall, despite further tightening of the labor market. Even though the labor market heated up and labor compensation rose, measured inflation fell, owing to the appreciation of the dollar, weakness in international commodity prices, and faster productivity growth.

Those restraining forces were more evident in goods-price inflation, which in the CPI slowed substantially to only about ½ percent in 1997, than on service-price inflation, which moderated much less—to around 3 percent. Providers of services appeared to be more pressed by mounting strains in labor markets. Hourly wages and salaries in service-producing sectors rose 4½ percent last year, up considerably from the prior year and almost 1½ percentage points faster than in goods-producing sectors. However, a significant portion of that differential, but by no means all, traced to commissions in the financial and real estate services sector related to one-off increases in transactions prices and in volumes of activity, rather than to increases in the underlying wage structure.

Although the nominal federal funds rate was maintained after March, the apparent drop in inflation expectations over the balance of 1997 induced some firming in the stance of monetary policy by one important measure—the real federal funds rate, or the nominal federal funds rate less a proxy for inflation expectations. Some analysts have dubbed the contribution of the reduction in inflation expectations to raising the real federal funds rate a "passive" tightening, in that it increased the amount of monetary policy restraint in place without an explicit vote by the FOMC. While the tightening may have been passive in that sense, it was by no means inadvertent. Members of the FOMC took some comfort in the upward trend of the real federal funds rate over the year and the rise in the foreign exchange value of the dollar because such additional restraint was viewed as appropriate given the strength of spending and building strains on labor resources. They also recognized that in virtually all other respects financial markets remained quite accommodative and, indeed, judging by the rise in equity prices, were providing additional impetus to domestic spending.

The Outlook for 1998

There can be no doubt that domestic demand retained considerable momentum at the outset of this year. Production and employment have been on a strong uptrend in recent months. Confident households, enjoying gains in income and wealth and benefitting from the reductions in intermediate- and longer-term interest rates to date, should continue to increase their spending. Firms should find financing available on relatively attractive terms to fund profitable opportunities to enhance efficiency by investing in new capital equipment. By itself, this strength in spending would seem to presage intensifying pressures in labor markets and on prices.

Yet, the outlook for total spending on goods and services produced in the United States is less assured of late because of storm clouds massing over the Western Pacific and heading our way.

This is not the place to examine in detail what triggered the initial problems in Asian financial markets and why the subsequent deterioration has been so extreme. I covered that subject recently before several committees of the Congress. Rather, I shall confine my discussion this morning to the likely consequences of the Asian crisis for demand and inflation in the United States.

With the crisis curtailing the financing available in foreign currencies, many Asian economies have had no choice but to cut back their imports sharply. Disruptions to their financial systems and economies more generally will further damp demands for our exports of goods and services. American exports should be held down as well by the appreciation of the dollar, which will make the prices of competing goods produced abroad more attractive, just as foreign-produced goods will be relatively more attractive to buyers here at home. As a result, we can expect a worsening net export position to exert a discernible drag on total output in the United States. For a time, such restraint might be reinforced by a reduced willingness of U.S. firms to accumulate inventories as they foresee weaker demand ahead.

The forces of Asian restraint could well be providing another, more direct offset to inflationary impulses arising domestically in the United States. In the wake of weakness in Asian economies and of lagged effects of the appreciation of the dollar more generally, the dollar prices of our non-oil imports are likely to decline further in the months ahead. These lower import prices are apparently already making domestic producers hesitant to raise their own prices for fear of losing market share, further contributing to the restraint on overall prices. Lesser demands for raw materials on the part of Asian economies as their activity slows should help to keep world commodity prices denominated in dollars in check. Import and commodity prices, however, will restrain U.S. inflation only as long as they continue to fall, or to rise at a slower rate than the pace of overall domestic product prices.

The key question going forward is whether the restraint building from the turmoil in Asia will be sufficient to check inflationary tendencies that might otherwise result from the strength of domestic spending and tightening labor markets. The depth of the adjustment abroad will depend on the extent of weakness in the financial sectors of Asian economies and the speed with which structural inefficiencies in the financial and nonfinancial sectors of those economies are corrected.

If, as we suspect, the restraint coming from Asia is sufficient to bring the demand for American labor back into line with the growth of the working-age population desirous of working, labor markets will remain unusually tight, but any intensification of inflation should be delayed, very gradual, and readily reversible. However, we cannot rule out two other, more worrisome possibilities. On the one hand, should the momentum to domestic spending not be offset significantly by Asian or other developments, the U.S. economy would be on a track along which spending could press too strongly against available resources to be consistent with contained inflation. On the other, we also need to be alert to the possibility that the forces from Asia might damp activity and prices by more than is desirable by exerting a particularly forceful drag on the volume of net exports and the prices of imports.

When confronted at the beginning of this month with these, for the moment, finely balanced, though powerful forces, the members of the Federal Open Market Committee decided that monetary policy should most appropriately be kept on hold. With the continuation of a remarkable seven-year expansion at stake and so little precedent to go by, the range of our intelligence gathering in the weeks ahead must be wide and especially inclusive of international developments.

The Forecasts of the Governors of the Federal Reserve Board and the Presidents of the Federal Reserve Banks

In these circumstances, the forecasts of the governors of the Federal Reserve Board and presidents of the Federal Reserve Banks for the performance of the U.S economy over this year are more tentative than usual. Based on information available through the first week of February, monetary policymakers were generally of the view that moderate economic growth is likely in store. The growth rate of real GDP is most commonly seen as between 2 and 2¾ percent over the four quarters of 1998. Given the strong performance of real GDP, these projections envisage the unemployment rate remaining in the low range of the past half year. Inflation, as measured by the four-quarter percent change in the consumer price index, is expected to be 1¾ to 2¼ percent in 1998—near the low rate recorded in 1997. This outlook embodies the expectation that the effects of continuing tightness in labor markets will be largely offset by technical adjustments shaving a couple tenths from the published CPI, healthy productivity growth, flat or declining import prices, and little pressure in commodity markets. But the policymakers' forecasts also reflect their determination to hold the line on inflation.

The Ranges for the Debt and Monetary Aggregates

The FOMC affirmed the provisional ranges for the monetary aggregates in 1998 that it had selected last July, which, once again, encompass the growth rates associated with conditions of approximate price stability, provided that these aggregates act in accord with their pre-1990s historical relationships with nominal income and interest rates. These ranges are identical to those that had prevailed for 1997—1 to 5 percent for M2 and 2 to 6 percent for M3. The FOMC also reaffirmed its range of 3 to 7 percent for the debt of the domestic nonfinancial sectors for this year. I should caution, though, that the expectations of the governors and Reserve Bank presidents for the expansion of nominal GDP in 1998 suggest that growth of M2 in the upper half of its benchmark range is a distinct possibility this year. Given the continuing strength of bank credit, M3 might even be above its range as depositories use liabilities in this aggregate to fund loan growth and securities acquisitions. Nonfinancial debt should come in around the middle portion of its range.

In the first part of the 1990s, money growth diverged from historical relationships with income and interest rates, in part as savers diversified into bond and stock mutual funds, which had become more readily available and whose returns were considerably more attractive than those on deposits. This anomalous behavior of velocity severely set back most analysts' confidence in the usefulness of M2 as an indicator of economic developments. In recent years, there have been tentative signs that the historical relationship linking the velocity of M2—measured as the ratio of nominal GDP to the money stock—to the cost of holding M2 assets was reasserting itself. However, a persistent residual upward drift in velocity over the past few years and its apparent cessation very recently underscores our ongoing uncertainty about the stability of this relationship. The FOMC will continue to observe the evolution of the monetary and credit aggregates carefully, integrating information about these variables with a wide variety of other information in determining its policy stance.

Uncertainty about the Outlook

With the current situation reflecting a balance of strong countervailing forces, events in the months ahead are not likely to unfold smoothly. In that regard, I would like to flag a few areas of concern about the economy beyond those mentioned already regarding Asian developments.

Without doubt, lenders have provided important support to spending in the past few years by their willingness to transact at historically small margins and in large volumes.

Equity investors have contributed as well by apparently pricing in the expectation of substantial earnings gains and requiring modest compensation for the risk that those expectations could be mistaken. Approaching the eighth year of the economic expansion, this is understandable in an economic environment that, contrary to historical experience, has become increasingly benign. Businesses have been meeting obligations readily and generating high profits, putting them in outstanding financial health.

But we must be concerned about becoming too complacent about evaluating repayment risks. All too often at this stage of the business cycle, the loans that banks extend later make up a disproportionate share of total nonperforming loans. In addition, quite possibly, twelve or eighteen months hence, some of the securities purchased on the market could be looked upon with some regret by investors. As one of the nation's bank supervisors, the Federal Reserve will make every effort to encourage banks to apply sound underwriting standards in their lending. Prudent lenders should consider a wide range of economic situations in evaluating credit; to do otherwise would risk contributing to potentially disruptive financial problems down the road.

A second area of concern involves our nation's continuing role in the new high-tech international financial system. By joining with our major trading partners and international financial institutions in helping to stabilize the economies of Asia and promoting needed structural changes, we are also encouraging the continued expansion of world trade and global economic and financial stability on which the ongoing increase of our own standards of living depends. If we were to cede our role as a world leader, or backslide into protectionist policies, we would threaten the source of much of our own sustained economic growth.

A third risk is complacency about inflation prospects. The combination and interaction of significant increases in productivity-improving technologies, sharp declines in budget deficits, and disciplined monetary policy has damped product price changes, bringing them to near stability. While part of this result owes to good policy, part is the product of the fortuitous emergence of new technologies and of some favorable price developments in imported goods. However, as history counsels, it is unwise to count on any string of good fortune to continue indefinitely. At the same time, though, it is also instructive to remember the words of an old sage that "luck is the residue of design."

He meant that to some degree we can deliberately put ourselves in position to experience good fortune and be better prepared when misfortune strikes. For example, the 1970s were marked by two major oil-price shocks and a significant depreciation in the exchange value of the dollar. But those misfortunes were, in part, the result of allowing imbalances to build over the decade as policymakers lost hold of the anchor provided by price stability. Some of what we now see helping rein in inflation pressures is more likely to occur in an environment of stable prices and price expectations that thwarts producers from indiscriminately passing on higher costs, puts a premium on productivity enhancement, and rewards more effectively investment in physical and human capital.

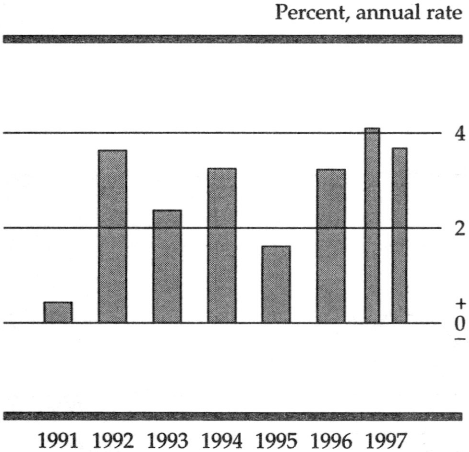
Simply put, while the pursuit of price stability does not rule out misfortune, it lowers its probability. If firms are convinced that the general price level will remain stable, they will reserve increases in their sales prices of goods and services as a last resort, for fear that such increases could mean loss of market share. Similarly, if households are convinced of price stability, they will not see variations in relative prices as reasons to change their long-run inflation expectations. Thus, continuing to make progress toward this legislated objective will make future supply shocks less likely and our nation's economy less vulnerable to those that occur.

Monetary Policy and the Economic Outlook

The U.S. economy turned in another excellent performance in 1997. Growth was strong, the unemployment rate declined to its lowest level in nearly a quarter-century, and inflation slowed further. Impressive gains were also made in other important respects: The federal budget moved toward balance much more quickly than almost anyone had anticipated; capital investment, a critical ingredient for long-run growth, rose sharply further; and labor productivity, the ultimate key to rising living standards, displayed notable vigor.

Change in Real GDP

Percent, annual rate

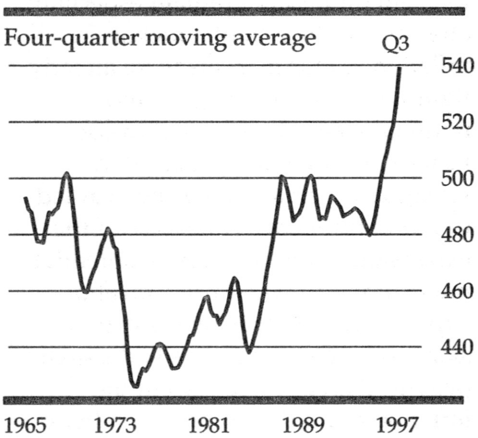


Note. In this chart and in subsequent charts that show the components of real GDP, changes are measured to the final quarter of the period indicated, from the final quarter of the previous period.

Among the influences that have brought about this favorable performance are the sound fiscal and monetary policies that have been pursued in recent years.

Household Net Worth

Percent of disposable personal income

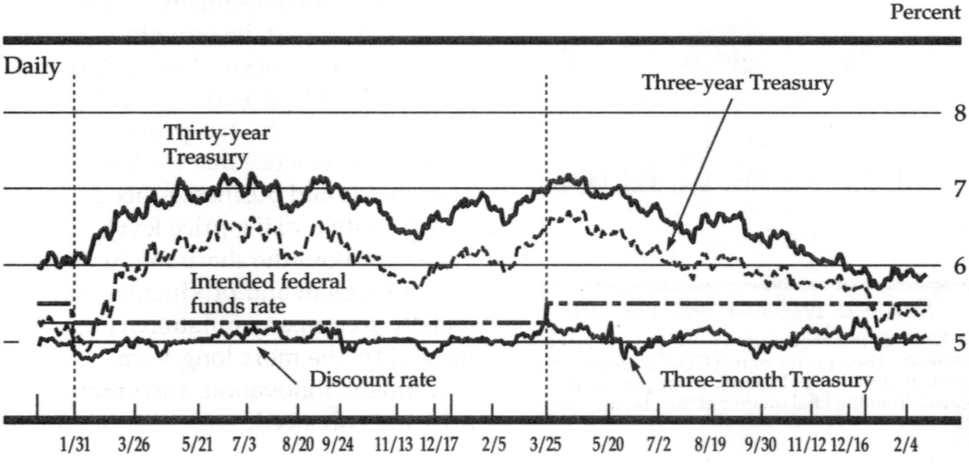


Budgetary restraint at the federal level has raised national saving, easing the competition for funds in our capital markets and thereby encouraging greater private investment. Monetary policy, for its part, has sought to foster an environment of subdued inflation and sustainable growth. The experience of recent years has provided additional evidence that the less households and businesses need to cope with a rising price level, or worry about the sharp fluctuations in employment and production that usually accompany inflationary instability, the more long-term investment, innovation, and enterprise are enhanced.

The circumstances that prevailed through most of 1997 required that the Federal Reserve remain especially attentive to the risk of a pickup in inflation. Labor markets were already tight when the year began, and nominal wages had started to rise faster than previously. Persistent strength in demand over the year led to economic growth in excess of the expansion of the economy's potential, intensifying the pressures on labor supplies. In earlier business expansions, such developments had usually produced an adverse turn in the inflation trend that, more often than not, was accompanied by a worsening of economic performance on a variety of fronts, culminating in recession.

Robust growth of spending early in the year heightened concerns among members of the Federal Open Market Committee (FOMC) that growing strains on productive resources might touch off a faster rate of cost and price rise that could eventually undermine the expansion. Financial market participants seemed to share these concerns: Intermediate- and long-term interest rates began moving up in December 1996, effectively anticipating Federal Reserve action. When the FOMC firmed policy slightly at its March meeting by raising the intended federal funds rate from 5¼ percent to 5½ percent, the market response was small.

Selected Interest Rates



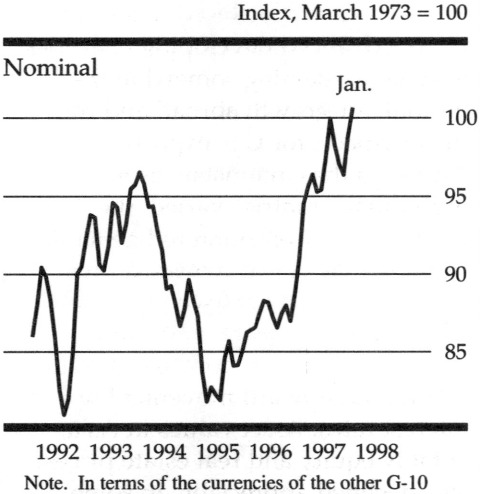
Note. Dotted vertical lines indicate days on which the Federal Open Market Committee (FOMC) announced a monetary policy action. The dates on the horizontal axis are those on which the FOMC held scheduled meetings. Last observations are for February 20, 1998.

The economy slowed a bit during the second and third quarters, and inflation moderated further. In addition, the progress being made by the federal government in reducing the size of the deficit was becoming more apparent. As a consequence, by the end of September, longer-term interest rates fell ¾ percentage point from their peaks in mid-April, leaving them about ¼ percentage point below their levels at the end of 1996. The decline in interest rates along with continued reports of brisk growth in corporate profits sparked increases in broad indexes of equity prices of 20 percent to 35 percent between April and September.

Even with a more moderate pace of growth, labor markets continued to tighten, generating concern among the FOMC members over this period that rising costs might trigger a rise in inflation. Consequently, at its meetings from May through November, the Committee adopted directives for the conduct of policy that assigned greater likelihood to the possibility of a tightening of policy than to the possibility of an easing of policy. Even though the Committee kept the nominal federal funds rate unchanged, it saw the rise in the real funds rate resulting from declining inflation expectations, together with the increase in the exchange value of the dollar, as providing some measure of additional restraint against the possible emergence of greater inflation pressures.

In the latter part of the year, developments in other parts of the world began to alter the perceived risks attending the U.S. economic outlook. Foreign economies generally had seemed to be on a strengthening growth path when the Federal Reserve presented its midyear monetary policy report to the Congress last July. But over the remainder of the summer and during the autumn, severe financial strains surfaced in a number of advanced developing countries in Asia, weakening somewhat the outlook for growth abroad and thus the prospects for U.S. exports. Although the circumstances in individual countries varied, the problems they encountered generally resulted in severe downward pressures on the foreign exchange values of their currencies; in many cases, steep depreciations occurred despite substantial upward movement of interest rates. Asset values in Asia, notably equity and real estate prices, also declined appreciably in some instances, leading to losses by financial institutions that had either invested in those assets or lent against them; nonfinancial firms began to encounter problems servicing their obligations. In many instances the debts of nonfinancial and financial firms were denominated in dollars and unhedged. Concerted international efforts to bring economic and financial stability to the region are under way, and some progress has been made, but it is evident that in several of the affected economies the process of adjustment will be painful. Meanwhile, economic activity in Japan stagnated, in part because of the developments elsewhere in East Asia, and the weaknesses in the Japanese financial system became more apparent.

Weighted Average G-10 Exchange Value of the U.S. Dollar

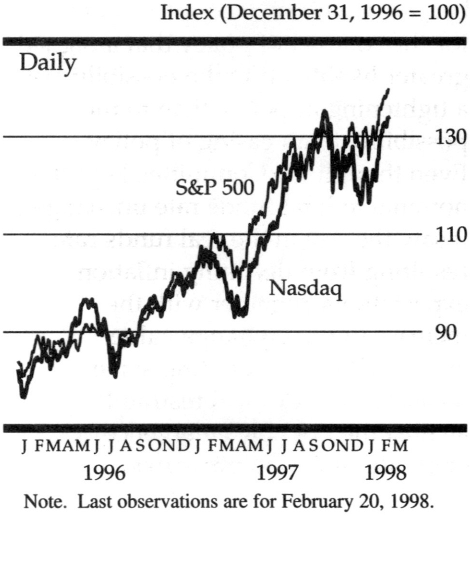


Note. In terms of the currencies of the other G-10 countries. Weights are based on 1972–76 global trade of each of the ten countries.

The steep depreciations of many Asian currencies contributed to a substantial further appreciation of the U.S. dollar. Measured against a broad set of currencies that includes those of the advanced developing countries of Asia, the exchange value of the dollar, adjusted for relative consumer prices, has moved up about 8 percent since October and has increased about 16 percent from its level at the end of 1996. The dollar has also appreciated, on balance, against an index of currencies of the G-10 (Group of Ten) industrial countries; this G-10 trade-weighted index of dollar exchange rates is up about 13 percent in nominal terms since the end of 1996.

The difficulties in Asia contributed to additional declines of ¼ to ½ percentage point in the yields on intermediate- and long-term Treasury securities in the United States between mid-autumn and the end of the year. These decreases were due in part to an international flight to the safe haven of dollar assets, but they also reflected expectations that these difficulties would exert a moderating influence on the growth of aggregate demand and inflation in the United States. Equity prices were quite volatile but showed little trend in the fourth quarter.

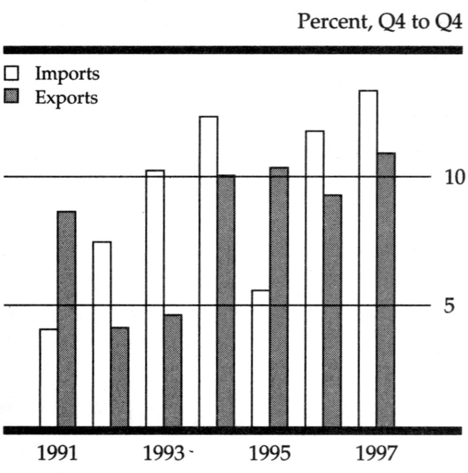
Major Stock Price Indexes



Note. Last observations are for February 20, 1998.

In light of the ongoing difficulties in Asia and the possible effects on the United States, the FOMC not only left interest rates unchanged in December, but shifted its instructions to the Manager of the System Open Market Account to symmetry between ease and tightening in the near term.

Change in Real Imports and Exports of Goods and Services



Some spillover from the problems in Asia has recently begun to appear in reports on business activity in the United States. Customers in the advanced developing countries reportedly have canceled some of the orders they had previously placed with U.S. firms, and companies more generally are expressing concerns about the possibilities of both reduced sales to Asia and more intense price competition here as the result of the sharp changes in exchange rates.

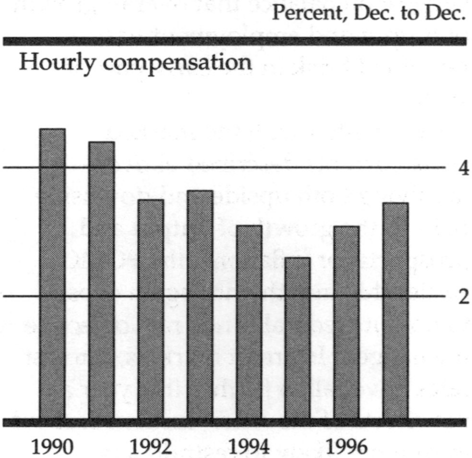
Nonetheless, the available statistics suggest on balance that overall growth of output and employment has remained brisk in the early part of 1998.

Confronted with the marked cross-currents described above—involving both upside and downside risks to the growth of output and prospects for inflation—the FOMC earlier this month once again chose to hold its federal funds rate objective unchanged. In credit markets, interest rates have fallen further this year as the effects of the Asian turmoil seemed even more likely to restrain any tendencies toward unsustainable growth and greater inflation in the United States. With interest rates lower and the negative effects of the Asian problems seen by market participants as mostly limited to particular sectors, broad indexes of equity prices have risen appreciably, many to new highs.

Economic Projections for 1998

The outlook for 1998 is clouded with a greater-than-usual degree of uncertainty. Part of that uncertainty is a reflection of the financial and economic stresses that have developed in Asia, the full consequences of which are difficult to judge. But there are some other significant question marks as well, many of them growing out of the surprising performance of the U.S. economy in 1997: Growth was considerably stronger and inflation considerably lower than Federal Reserve officials and most private analysts had anticipated.

Change in Employment Cost Index



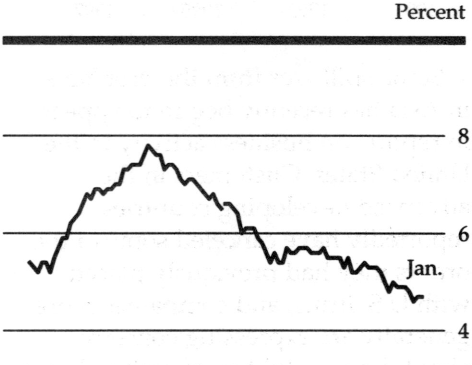
Note. Private industry excluding farm and household workers.

Some of the key forces that gave rise to this favorable performance can be readily identified. An ongoing capital spending boom, encouraged in part by declining prices of high-technology equipment, provided stimulus to aggregate demand and at the same time created the additional capacity to help meet that demand. A further jump in labor productivity that was fueled partly by the buildup of capital helped firms overcome the production and pricing challenges posed by tight labor markets. A surprisingly robust stock market bolstered the finances of households and enabled them to spend more freely. Falling world oil prices reduced the prices of petroleum products and helped hold down the prices of other energy-intensive goods. Finally, a rising dollar imposed additional restraint on inflation, as prices of imported goods fell appreciably.

Circumstances as favorable as those of 1997 are not likely to persist, although several elements in the recent mix could help maintain, for some time, a more favorable economic performance than historical relationships would suggest.

In assessing the situation, the members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, think that the most likely outcome for 1998 will be one of moderate growth, low unemployment, and low inflation. Most of them have placed their point estimates of the rise in real GDP from the fourth quarter of 1997 to the fourth quarter of 1998 in the range of 2 percent to 2¾ percent. The civilian unemployment rate in the fourth quarter of 1998 is expected to be at about its recent level.

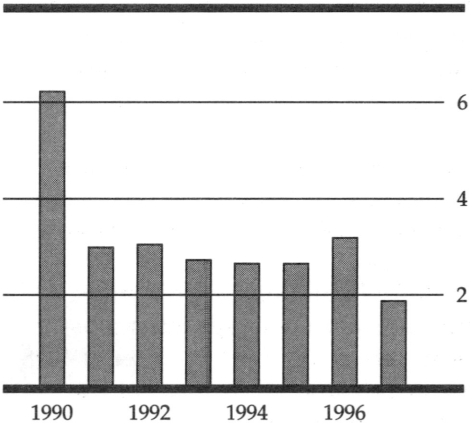
Civilian Unemployment Rate



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.

Change in Consumer Prices

Percent, Q4 to Q4



Note. Consumer price index for all urban consumers.

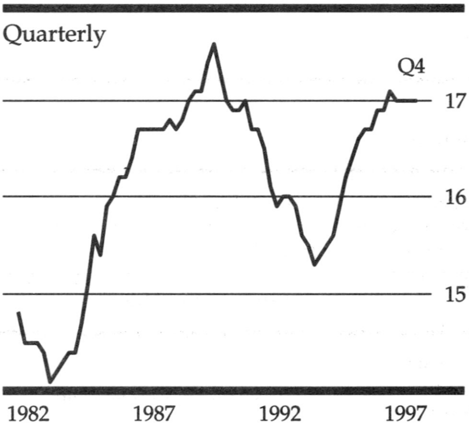
For the most part, the forecasts have the total CPI for all urban consumers rising between 1¾ percent and 2¼ percent this year. These predictions do not differ appreciably from those recently put forth by the Administration.

Although developments in Asia over the past few months have not yet affected aggregate U.S. economic performance in a measurable way, these influences will likely become more visible in coming months. Growth of U.S. exports is expected to be restrained by weaknesses in Asian economies and by the lagged effects of the appreciation of the dollar since 1995. Moreover, with the rise in the dollar's value making imports less expensive, some U.S. businesses and consumers will likely switch from domestic to foreign sources for some of their purchases. But the timing and magnitude of these developments are hard to predict.

In contrast to the slower growth that seems to be in prospect for exports, domestic spending seems likely to maintain considerable strength in coming quarters. Households as a group are quite upbeat in their assessments of their personal finances—as might be expected in conjunction with expanding job opportunities, rising incomes, and huge gains in wealth. Recently, many households have taken advantage of lower long-term interest rates by refinancing their home mortgages, and this will provide a little additional wherewithal for spending. Moreover, the decline in mortgage rates is also bolstering housing construction.

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.

Business outlays for fixed investment seem likely to advance at a relatively brisk pace in the coming year, although gains as large as those of the past couple of years may be difficult to match. Outlays for computers, which have dominated the investment surge of the past few years, should climb substantially further as businesses press ahead with new investment in the latest technologies, encouraged in part by ongoing price declines. With labor markets tight, firms continue to see capital investment as the key in efforts to increase efficiency and maintain competitiveness. Internally generated funds remain adequate to cover the bulk of businesses' investment outlays, and those firms turning to the debt and equity markets are most often finding financing generously available on good terms. Inventory growth will likely put less pressure on business cash flow this year; after adding to stocks at a substantial clip in 1997, businesses seem likely to scale back such investment somewhat, especially as they perceive a moderation in sales increases.

The Federal Reserve policymakers' forecasts of the average unemployment rate in the fourth quarter of 1998 are mostly around 4¾ percent. The persistence for another year of this degree of tightness in the labor market means that firms will likely continue to face difficulties in finding workers

Economic Projections for 1998

Percent

Indicator		Federal Reserve Governors and Reserve Bank Presidents: Range	Central tendency	Administration
Change, fourth quarter to fourth quarter:[1]	Nominal GDP	3½–5	3¾–4½	4.0
	Real GDP[2]	1¾–3	2–2¾	2.0
	Consumer price index[3]	1½–2½	1¾–2¼	2.2
Average level, fourth quarter:	Civilian unemployment rate	4½–5	about 4¾	5.0

1. Change from average for fourth quarter of 1997 to average for fourth quarter of 1998.

2. Chain-weighted.

3. All urban consumers.

and that hiring and retaining workers could become more costly. Indeed, there are indications that wage inflation picked up further at the end of last year. Improvements in labor productivity have become more sizable in the past couple of years, and if such gains can be extended, wage increases of the magnitude of those of 1997 need not translate into greater price inflation. The more rapid growth in productivity is consistent with the high level of capital investment in recent years, but the extent to which the trend in productivity has picked up is still uncertain. Furthermore, if momentum in nominal wages continues to build, the pay increases will eventually squeeze profit margins and place upward pressures on prices, even with exceptional productivity gains. The strains in labor markets therefore constitute an ongoing inflationary risk that will have to be monitored closely.

In the near term, however, there are several factors that should lessen the risk of a step-up in inflation. Manufacturing capacity remains ample, and bottlenecks are not hampering production. The recent appreciation of the dollar should damp inflation both because of falling import prices and because the added competition from imports may induce domestic producers to hold down prices. Oil prices have weakened considerably since the latter part of 1997 in response to abundant supplies, the softening of demand in Asia, and a mild winter. Ample supplies and the prospect of softer global demand have been depressing the prices of many other commodities, both in agriculture and in industry. Perhaps most important, as the low level of inflation that has prevailed in recent years gets built into wage agreements, other contracts, and individuals' inflation expectations, it will provide an inertial force helping sustain the favorable price performance for a time.

Although many of the factors currently placing restraint on inflation are not necessarily long lasting, the Committee judged that their effect in 1998 would about offset the pressures from tight labor markets. Consequently, the Board members and Reserve Bank presidents anticipate that the rate of price inflation will change little this year. Again in 1998, the FOMC will be monitoring a variety of price measures in addition to the CPI for indications of changes in inflation and will be assessing movements in the CPI in the context of ongoing technical improvements by the Bureau of Labor Statistics that are likely to damp the reported 1998 rise in that index.

Money and Debt Ranges for 1998

In establishing the ranges for growth of broad measures of money over 1998, the Committee recognized the considerable uncertainty that still exists about the behavior of the velocities of these aggregates.

The velocity of M3 (the ratio of nominal GDP to the monetary aggregate) in particular has proved difficult to predict. Last year, the growth of this aggregate relative to spending was affected by the rapid increase in depository credit and by the way in which that increase was funded, as well as by the changing cash management practices of corporations, which have been using the services of institution-only money funds in M3. These factors boosted M3 growth last year to 8¾ percent, 3 percentage points faster than nominal GDP—an unusually large decline in M3 velocity. Going forward, it seems likely that M3 growth will continue to be buoyed by robust credit growth at depositories and continuing shifts in cash management. Thus, its velocity is likely to decline further, though the amount of decline is difficult to predict.

Ranges for Growth of Monetary and Debt Aggregates

Percent

Aggregate	1996	1997	1998
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.

The relationship of M2 to spending in recent years has come back more into line with historical patterns in which the velocity of M2 tended to be fairly constant, except for the effects of the changing opportunity cost of M2—the spread between yields that savers could earn holding short-term market instruments and those that they could earn holding M2. In the early 1990s, M2 velocity departed from this pattern, rising substantially and atypically. Even after the unusual shift of the early 1990s died out, M2 velocity continued to drift somewhat higher from 1994 into 1997. That drift probably reflected some continued, albeit more moderate, redirection of savings into bond and equity markets, especially through the purchase of mutual funds. However, last year the drift abated. There was little change, on balance, in the opportunity cost of holding M2, and M2 velocity also was about unchanged, as M2 grew 5½ percent, nearly the same as nominal GDP. Nevertheless, the upward drift could resume in the years ahead as financial innovations or perceptions of attractive returns lead households to further shift their savings away from M2 balances. Or velocity might be pushed downward if volatility or setbacks in bond and stock markets were to lead investors to seek the safety of M2 assets, which have stable principal.

In light of the uncertainties about the behavior of velocities, the Committee followed its practice of recent years and established the ranges for 1998 not as expectations for actual money growth, but rather as benchmarks for M2 and M3 behavior that would be consistent with sustained price stability, assuming velocity change in line with pre-1990 historical experience. Thus, the ranges for fourth-quarter to fourth-quarter growth are unchanged from those in 1997: 1 percent to 5 percent for M2, and 2 percent to 6 percent for M3. Given the central tendency of the Committee's forecast for growth of nominal GDP of 3¾ percent to 4½ percent, M2 is likely to be in the range, perhaps in the upper half, if short-term interest rates do not change much and velocity continues recent patterns. For M3, however, a continuation ofrecent velocity behavior could imply growth around the upper end of, if not above, the price-stability range.

Debt of the nonfinancial sectors grew 4¾ percent in 1997, near the middle of the range of 3 percent to 7 percent established by the Committee last February. As with the monetary aggregates, the Committee has left the range for debt unchanged for 1998. The range it has chosen encompasses the likely growth of debt given Committee members' forecasts of nominal GDP. Except for the 1980s, the growth of debt has tended to be reasonably in line with the growth of nominal GDP.

Although the ranges for money and debt are not set as targets for monetary policy in 1998, the behavior of these variables, interpreted carefully, can at times provide useful information about the economy and the workings of the financial markets. The Committee will continue to monitor the movements of money and debt—along with a wide variety of other financial and economic indicators—to inform its policy deliberations.

Growth of Money and Debt

Percent

Period		M1	M2	M3	Domestic nonfinancial debt
Annual[1]	1987	6.3	4.2	5.8	9.9
	1988	4.3	5.7	6.3	8.9
	1989	.5	5.2	4.0	7.8
	1990	4.2	4.1	1.8	6.8
	1991	7.9	3.1	1.2	4.5
	1992	14.4	1.8	.6	4.7
	1993	10.6	1.3	1.1	5.1
	1994	2.5	.6	1.7	5.1
	1995	–1.6	3.9	6.1	5.4
	1996	–4.5	4.6	6.9	5.2
	1997	–1.2	5.6	8.7	4.7
1997 Quarterly *(annual rate)*[2]	Q1	–1.4	5.1	8.0	4.3
	Q2	–4.5	4.4	7.7	4.7
	Q3	.3	5.4	8.1	4.1
	Q4	.8	6.8	9.8	5.2

Note. M1 consists of currency, travelers checks, demand deposits, and other checkable deposits. M2 consists of M1 plus savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds. M3 consists of M2 plus large-denomination time deposits, balances in institutional money market funds, RP liabilities (overnight and term), and Eurodollars (overnight and term). Debt consists of the outstanding credit market debt of the U.S. government, state and local governments, households and nonprofit organizations, nonfinancial businesses, and farms.

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.

2. From average for preceding quarter to average for quarter indicated.

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