

Federal Reserve System -- Monetary Policy Report [1985 Series]

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# Monetary Policy Objectives for 1985

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Summary Report of the Federal Reserve Board

Federal Reserve System, Board of Governors

February 20, 1985

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# Monetary Policy Objectives for 1985

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Summary of Report to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978. February 20, 1985.

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# The Outlook for the Economy in 1985

## Prospects and Problems

Nineteen eighty-four was another year of substantial economic growth in the United States. Production and employment gains were large, making the expansion of the past two years—with growth in real gross national product averaging 6 percent per year—the strongest cyclical upswing since the early 1950s. Moreover, continued vigor of the economy was accompanied by signs of some further lowering of inflationary expectations. Aggregate price measures rose around 4 percent last year, about the same as during the two preceding years. While prices of services continued to rise by 5 to 6 percent, prices of many goods were relatively flat, and underlying wage trends seemed to be moderating.

Economic growth had been extraordinarily rapid in the first half of 1984, and then slowed abruptly around midyear. Although some slowing in growth was widely anticipated, the abruptness of the change raised some question about the continuing strength of expansionary forces. However, during the last few months of the year, output and employment were clearly rising, though at a more moderate pace than earlier in the year.

The strong gains in overall activity during the year drew attention away from a number of continuing problems, but those problems were nonetheless real and serious. The overall rate of unemployment is still uncomfortably high and the joblessness among certain groups—for example, teenagers and blacks—remains well above the average. Sectors of the economy facing intense competition from abroad, such as agriculture and certain mining and manufacturing industries, have not participated in the rapid economic expansion overall, and have been under strong financial stress. Strains also

remain evident among financial institutions: a number of depository institutions have experienced a deterioration of the quality of their loan portfolios and the earnings of thrift institutions remain constrained by low-yielding assets accumulated in earlier years.

While it has not been an impediment to economic expansion to date, growth in credit has been exceptionally rapid and many households and businesses have accumulated substantial indebtedness, often in short-term or variable-rate forms that make them especially vulnerable to unexpected economic developments. Also, despite the impetus from strong U.S. demand, growth in economic activity has been limited in a number of important industrialized countries, and many developing countries, in Latin America and elsewhere, are still struggling to restore satisfactory growth. While progress was made in stabilizing the external finances of some of the largest of those countries, that progress can only be secure in the context of greater stability in their own economies and of sustained growth in the industrialized world.

It is also evident that the enormous imbalances in our federal fiscal posture and in our trade and current account position have aggravated certain problems and made constructive solutions much more difficult. In an expanding economy requiring more private credit, the need for credit to finance the large federal deficits has contributed to the pressures that have held real interest rates at historically high levels. The failure to deal with budgetary deficits also has sustained doubts in the minds of the public about the ability of the government to continue to curb inflation over the long run.

The large federal deficits are mirrored in our external imbalance. Many foreign investors have been attracted to the comparatively high real rates of return offered on dollar-denominated assets, and U.S. lending abroad has been reduced. Other forces stimulating capital inflows have been at work, including political and economic uncertainties in other countries and the relative stability and vigor of our economy. The shift in capital flows has supplemented domestic saving and helped finance the federal government deficit and private investment. But, at the same time, the strong demand for the dollar has driven its value on foreign exchange markets to

extremely high levels. As the dollar has appreciated, the demand for our exports has suffered and our purchases of imported goods have increased dramatically, resulting in strong pressures on the manufacturing, mining, and agricultural sectors and leading to calls for protectionist measures. Moreover, the capital inflows lead to mounting financial claims of foreigners that the nation must be prepared to deal with in future years through reduced imports or increased exports, in either case lowering domestic consumption.

### Economic Projections

Notwithstanding the risks associated with these domestic and international problems, the weight of the evidence points to reasonably favorable near-term prospects for aggregate economic performance. In recent months, personal income growth has been strong, reflecting continuing substantial gains in employment, and helping to support consumer spending. Overbuilding of multifamily residential units and offices in some parts of the country may pose questions about the outlook in these areas, but the lower interest rates that developed over recent months suggest that single-family homebuilding may strengthen. Surveys of businesses indicate plans for continued growth in plant and equipment spending in the coming months, though at a slower pace than last year. Meanwhile, some imbalances in business inventories that developed during 1984 appear to be

well along in the process of correction, and in some sectors inventories are quite lean relative to sales. Many states and localities are experiencing an improvement in their finances, which portends further support to the expansion from that sector, and at the Federal level, there continues to be a strong stimulative thrust from fiscal policy.

The smallest increases in nominal wages and compensation in more than a decade have been accompanied by an improvement in productivity and downward pressures on energy and commodity prices. These developments help support the possibilities of continuing restraint in price increases. Also, in the context of an economy expanding at a sustainable rate, they are consistent with continuing growth in average real income.

Taking account of these factors, the members of the Federal Open Market Committee (as well as Federal Reserve Bank Presidents who are not at present FOMC members) foresee the probable continuation of the economic expansion through its third year, although at a more moderate pace than in the first two years. In their forecasts, the Committee members assumed that the exchange rate would remain within the range of recent months and that effective fiscal action is in prospect.

### Economic Projections for 1985 (percent)

		FOMC members and other FRB Presidents		Administration	CBO
		Range	Central Tendency		
Change, fourth quarter to fourth quarter:	Nominal GNP	7 to 8½	7½ to 8	8.5	7.7
	Real GNP	3¼ to 4¼	3½ to 4	4.0	3.4
	Implicit deflator for GNP	3 to 4¼	3½ to 4	4.3	4.2
Average level in the fourth quarter:	Unemployment Rate	6½ to 7¼	6¾ to 7	6.9	7.0

# Monetary Policy in 1985

At its February meeting, the FOMC set monetary and credit growth ranges for 1985 designed to be consistent with further sustainable economic growth and progress toward reasonable price stability over time. The growth ranges for the monetary and credit aggregates for 1985 are shown below.

The upper end of the range for M1 is one percentage point below that of 1984, and the range for M2 is the same as last year's. The upper end of the target range for M3 is slightly above that for last year. That increase, as well as the upward adjustment in the associated monitoring range for the debt of domestic nonfinancial sectors, reflects analysis of developments during 1984 suggesting that growth somewhat greater than anticipated earlier may be consistent with Committee objectives for the year. Expansion within these ranges would represent a significant deceleration in the actual growth of M3 and debt from the experience of last year when the target ranges were exceeded.

In formulating these objectives, the Committee assumed that no new statutory or regulatory developments would be enacted that would appreciably influence the behavior of the monetary and credit aggregates in 1985.

On average, the behavior of M1 velocity—nominal GNP divided by the money stock—during

## Ranges of Monetary Growth 1985<sup>1</sup>

Measured from fourth quarter 1984 to fourth quarter 1985

M1	4 to 7 percent
M2	6 to 9 percent
M3	6 to 9½ percent
Total Domestic Nonfinancial Debt	9 to 12 percent

1984 was broadly consistent with previous cyclical patterns. Together with other evidence, this development suggests that the factors responsible for the unusually high velocity behavior over 1982 and early 1983 have receded.

Nonetheless, a range of uncertainty inevitably remains about the trend of M1 relative to nominal GNP in light of recent deposit deregulation and other financial innovations that have affected the funding policies of banks and the cash management practices of the public. On balance, it appears likely that the process of deposit deregulation will lead to a trend rate of increase in the velocity of M1 that may be somewhat lower than in the post-World War II period as a whole. However, in view of the multiplicity of changes in financial instruments and practices that influence the behavior of all the monetary measures, interpretation of all the aggregates will continue to be made within the context of the outlook for economic activity, inflationary pressures, and conditions in domestic and international financial markets, including the strength of credit demands.

## M1 Growth

The new target range for M1 encompasses growth in M1 consistent with velocity expansion over the coming year approximating that of last year, and also higher M1 growth that would be needed should velocity grow at a rate approximating the reduced trend suggested above. The movements in velocity during 1984 occurred in a context of moderate increases in interest rates over much of the year; however, velocity has slowed substantially in recent months in the context of an appreciable rise in money growth and following declines in interest rates. In all the circumstances, a somewhat higher rate of money growth than implied by straight line projections from the fourth quarter 1984 base to the targets for the fourth quarter of 1985 may be appropriate early in the year, but growth of M1 would be expected to slow, and velocity growth to rise, as the current adjustments are completed. Thus, as the year progresses, growth of M1 would be expected to move gradually toward and into the FOMC's target range. Depending upon develop-

ments with respect to velocity and price behavior, growth in M1 and the other monetary aggregates in the upper parts of their ranges may be appropriate over the year as a whole. Those developments will, of course, be closely monitored over the year.

### Growth of the Broader Aggregates

Like M1, growth of M2 and M3 has been particularly strong in recent months, reflecting the unusually favorable yield spreads in favor of monetary assets that emerged temporarily toward the end of last year. In addition, M3 growth has reflected substantial issuance of large CDs by thrift institutions to support their lending in mortgage and consumer loan markets.

Growth of the broader monetary aggregates is influenced, as well, by the pattern of international capital inflows associated with the huge current account deficit. By reducing the need for funding through other managed liabilities included in M2 and M3, these inflows tend to restrain measured monetary growth in relation to growth of bank credit and credit generally. Moreover, many domestic borrowers, including the federal government and private corporations, may continue to tap overseas securities markets directly, reducing the need for credit expansion by U.S. intermediaries.

Given the federal budget deficit as projected by the Administration for 1985—as well as an expansion of spending by domestic sectors in excess of nominal GNP growth, as part of that spending flows abroad—the Committee contemplates that domestic nonfinancial debt may continue to increase more

rapidly than nominal GNP. Still, actual growth of debt in 1985 should be markedly less than in 1984, as nominal GNP growth and overall credit demands moderate. Growth within the debt range for 1985 assumes also a slowing in credit for mergers, leveraged buyouts, and other financial restructuring. Such credit led to some erosion in corporate equity cushions last year, and a more cautious approach is anticipated this year.

The outlook for financial conditions generally is again expected to be affected importantly by current and prospective federal budget deficits, which will remain enormous in comparison with experience in previous economic expansions. This massive federal borrowing will compete for available domestic savings with the strong private credit demands accompanying further growth of economic activity, keeping interest rates and exchange rates higher than they otherwise would be. Such relatively high interest rates and exchange rates limit expansion in those sectors that are most sensitive to the cost of credit and impair the competitive positions of domestic import-competing and export industries. Decisive and credible actions to reduce federal budget deficits would have favorable effects on investors' expectations and help to lower interest rates, especially longer-term rates, even before these reductions become fully effective. Such actions would work to relieve the imbalances and strains within the economy, contribute to further abatement of inflationary expectations, and so reinforce the prospects for continued growth and stability.

### Growth of Aggregates 1984<sup>2</sup>

	1984 Range	1984 Actual	1984 Q4 Levels*
M1	4 to 8 percent	5.2 percent	553.7
M2	6 to 9 percent	7.7 percent	2345.4
M3	6 to 9 percent	10.5 percent	2960.6
Total Domestic Nonfinancial Debt	8 to 11 percent	13.4 percent	5869.7

\*Billions of dollars seasonally adjusted

# Monetary Policy and the Performance of the Economy in 1984

## The Growth of Money and Credit in 1984

Monetary policy in 1984 aimed basically at supporting sustainable economic growth within the context of long-term progress toward price stability.

Underlying these objectives was the Committee's expectation that the special factors distorting monetary growth rates in 1982 and 1983 would be less important in 1984, and that relationships among the monetary aggregates—particularly M1—and economic activity and inflation would be more consistent with historical trends and cyclical patterns. Portfolio adjustments associated with the previous introduction of new deposit accounts and with the steep drop in interest rates during the 1982 recession appeared to have ended. Furthermore, the economic expansion seemed to be reducing uncertainties about employment and income prospects that earlier had boosted demands for liquid precautionary balances.

Over the year, increasing evidence suggested that M1 was in fact behaving more in line with historical

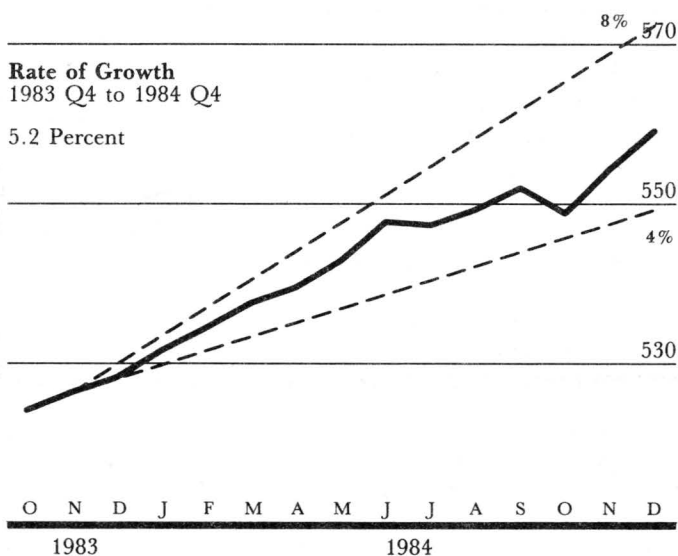
### M1

Billions of dollars

--- Range adopted by FOMC for 1983 Q4 to 1984 Q4

Rate of Growth  
1983 Q4 to 1984 Q4

5.2 Percent



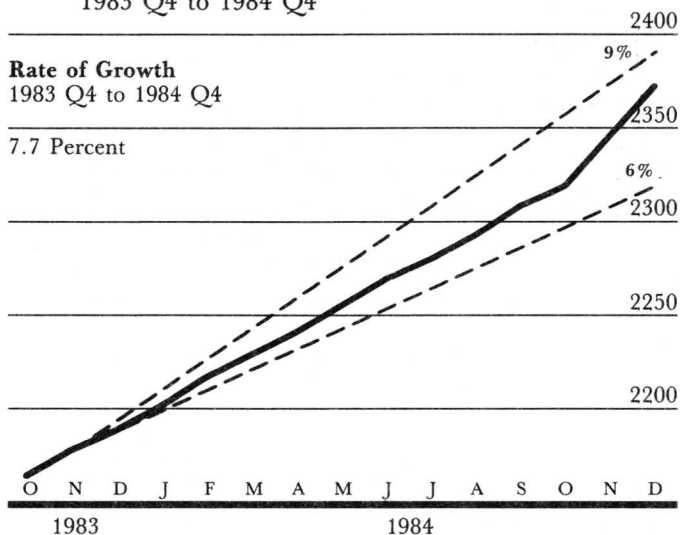
### M2

Billions of dollars

--- Range adopted by FOMC for 1983 Q4 to 1984 Q4

Rate of Growth  
1983 Q4 to 1984 Q4

7.7 Percent



experience. As a result, this aggregate was given more weight in policy implementation than had been the case during the latter part of the cyclical downswing and early phase of the economic recovery. However, all of the monetary and credit measures continued to be evaluated in light of the outlook for the economy and domestic and international financial markets.

The actual growth rates of M1 and M2 over 1984 were well within the target ranges established by the Federal Reserve. As had been anticipated in the mid-year policy report to the Congress, growth of M3 and domestic nonfinancial debt exceeded their ranges. The relatively wide divergence between M2 and M3 growth rates reflected mainly substantial issuance of large CDs and other managed liabilities by thrift institutions and commercial banks in the face of heavy credit demands.

Credit growth last year was the most rapid on record, and much stronger relative to GNP expansion than historical trends would suggest. An unusually large volume of mergers and related activity, including "leveraged buyouts," involving nonfinancial corpora-

tions, accounted for about 1 percentage point of the growth of overall debt. Around \$75 billion of equity was liquidated in this process, with much of it replaced, at least for a time, with short-term debt.

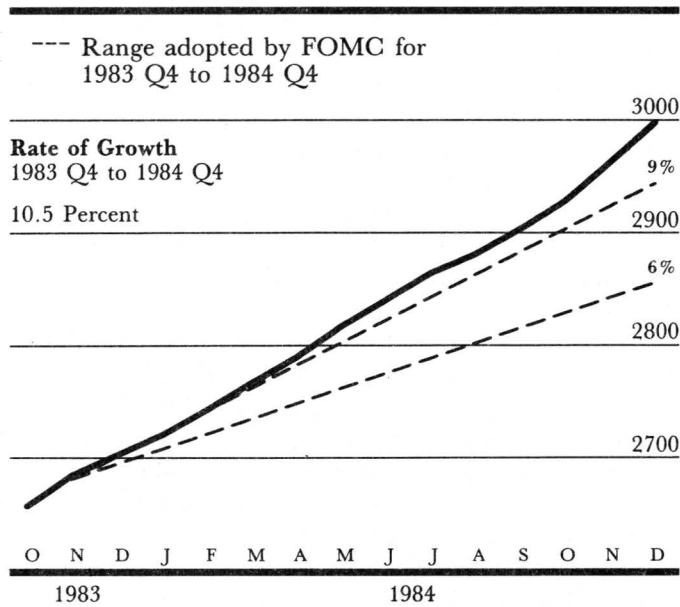
Even after allowance is made for the unusually large volume of merger-related borrowing, it is clear that total credit demands were exceptionally strong last year. Federal debt expansion, at more than 16 percent, was unprecedented for the second year of an economic expansion, both in absolute terms and in relation to income. Private domestic nonfinancial debt grew about 11½ percent (abstracting from growth of merger-related debt issues), also faster than, but much closer to, comparable stages of previous recoveries.

### Economic Performance in 1984

The economy recorded major gains in 1984, with the real gross national product up 5½ percent and the unemployment rate down more than 1 percentage

### M3

Billions of dollars



### Growth of Money and Credit (Percentage changes)<sup>3</sup>

Period		M1	M2	M3	Domestic Nonfinancial Debt
Fourth quarter to fourth quarter	1979	7.5	8.1	10.3	12.1
	1980	7.5	9.0	9.6	9.6
	1981	5.1 (2.5)*	9.3	12.4	10.0
	1982	8.8	9.1	10.0	9.1
	1983	10.4	12.2	10.0	10.8
	1984	5.2	7.7	10.5	13.4
Quarterly growth rates 1984	Q1	6.2	7.2	9.2	12.9
	Q2	6.5	7.1	10.5	13.1
	Q3	4.5	6.9	9.5	12.7
	Q4	3.4	9.0	11.0	12.7

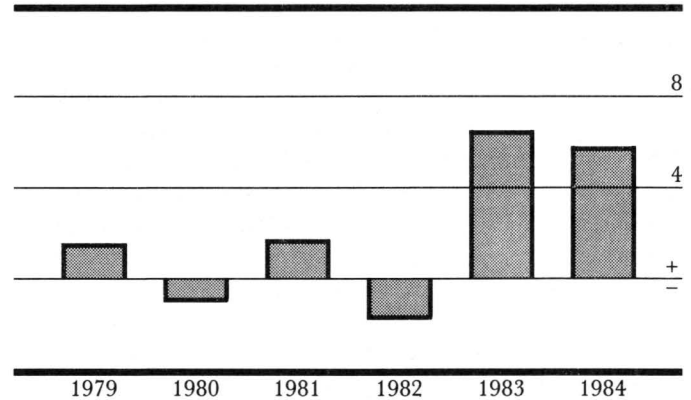
point over the year. The growth in output and employment was exceptionally strong in comparison with experience in other post-Korean War expansions. But even more striking, in terms of its departure from past norms, was the extraordinary rise in domestic spending, which again appreciably outstripped growth in domestic production. Over the course of the year such spending rose 6¾ percent in real terms. Consumers and businesses purchased greatly increased quantities of imported goods, whose relative prices were lowered by the appreciation of the dollar in exchange markets, and the U.S. trade deficit reached record proportions.

Last year's economic gains were achieved without a pickup in inflationary pressures, in part owing to the rise in the exchange value of the dollar. Aggregate indexes of prices rose about 4 percent or less, similar to rates of inflation recorded in 1983. Ample availability of industrial capacity here and abroad helped to contain price increases. Labor cost pressures also were limited, as wage increases actually were slightly lower than a year earlier. Labor markets continued to reflect the still considerable unemployment in the economy as well as the adjustments of wages in some sectors to the realities of forces associated with deregulation and foreign competition. Wage changes also reflected the favorable feedback effect of lower inflation on anticipatory or catch-up pay demands.

Although the nation as a whole has made great progress in the past two years toward the goals of sustained growth and high employment along with price stability, many segments of the economy have continued to experience considerable difficulty. One symp-

## Real GNP

Percent change, Q4 to Q4



tom of continuing imbalances has been interest rates that, relative to the prevailing rate of inflation, have remained exceptionally high by historical standards. However, after moving upward during the first half of the year when economic expansion was especially brisk, interest rates retraced their advances in the second half of the year. At year-end, they were, on balance, a little lower.

Federal government tax and spending policies have provided substantial stimulus to aggregate demands for goods and services, but in credit markets the deficits have added strongly to the demands for funds and have been one important force keeping interest rates high. Moreover, there is general agreement that unless legislative measures are enacted, budget deficits are likely to increase further, even in the context of a reasonably growing economy. This prospect, with its implication of continuing pressures on the supply of savings, has been a factor in the rise in the foreign exchange value of the dollar and the attendant emergence of enormous deficits in our trade and current accounts with other nations. Although the sharply higher value of the dollar has been an important fac-

tor in the movement toward price stability, inflationary pressures could become more apparent if the U.S. dollar were to decline sharply—a risk that could increase as fundamentally unsustainable fiscal and external postures are extended.

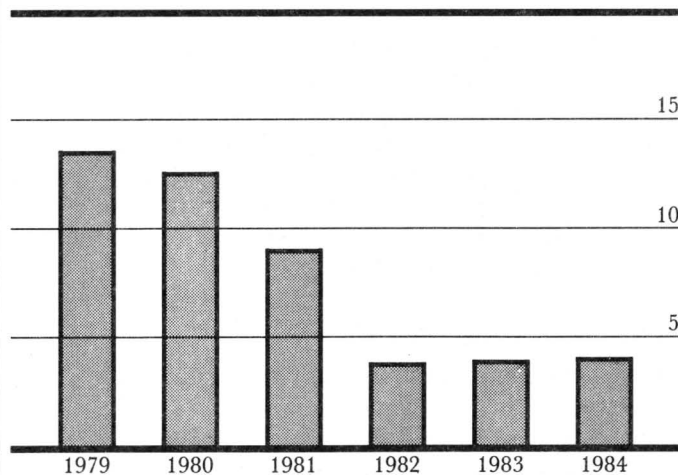
### Household Sector

The household sector continued to benefit last year from the economic expansion. Adjusting for inflation, the rise in disposable income from the fourth quarter of 1983 to the fourth quarter of 1984 was 5¾ percent, surpassing the large gain in 1983. This strong increase in income supported a rapid rise in spending for consumer goods even as the personal saving rate rose.

Growth of household indebtedness picked up noticeably last year, and consumer installment debt as a share of disposable income moved to near its previous peak in the late 1970s. Despite the rise in indebtedness, there were few signs of increased financial stress in the household sector. The incidence of payment difficulties on consumer installment debt remained historically low and home mortgage delinquency rates were about unchanged for the year as a whole. Nonetheless, the proportion of problem loans in the home mortgage market has not receded from its recession high, and there is some special concern about future

### Consumer Prices

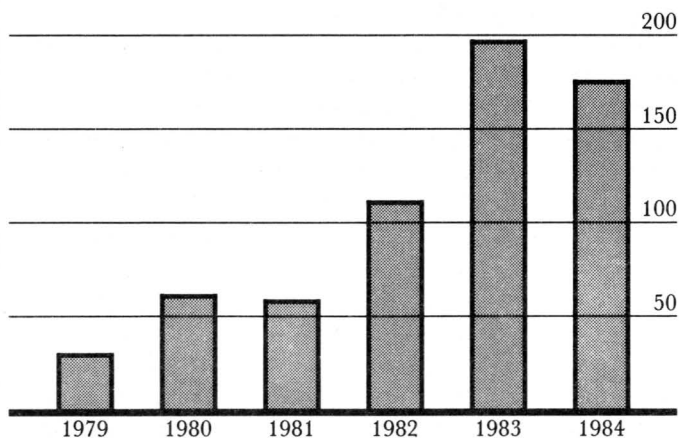
Percent change,  
December to December



### Federal Government Deficit

Billions of dollars

Fiscal Years, Unified Budget Basis



prospects in this area owing to the added risk exposure of homeowners who took on mortgages carrying adjustable features, especially those made with sizable initial interest rate concessions. The sustained high level of mortgage loan delinquencies appears to date attributable not so much to adjustable rate loans as to a combination of still high unemployment and more stable real estate prices than some borrowers had anticipated.

### Business Sector

The increase in business spending for plant and equipment was greater in 1984 than in 1983. In fact, the rise in gross business capital outlays over these two years combined was much larger than in any other post-World War II economic expansion. Profits in the nonfinancial corporate sector were up

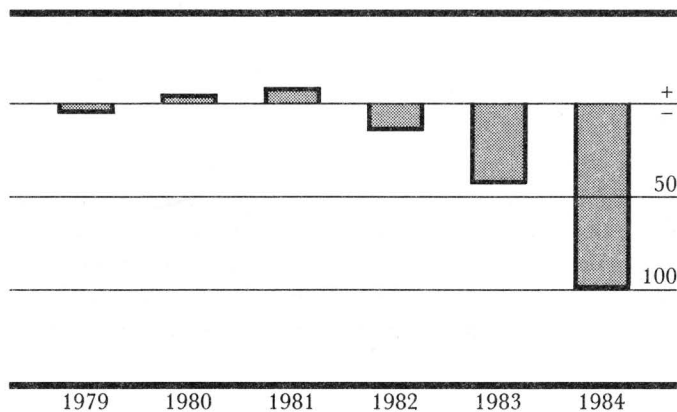
substantially in 1984, although by year-end the level had fallen back a bit owing to the slowing in sales growth.

Continued competitive pressure from foreign producers provided additional impetus for rapid modernization. At the same time, many U.S. producers of capital equipment, especially outside the "high-tech" area, did not fully benefit from this spending. Instead, foreign manufacturers captured an increasing share of capital goods purchased by U.S. firms; for domestic spending, this share—approximately 25 percent—was nearly twice that experienced in the late 1970s.

Severe financial strains, in many cases related to the high exchange value of the dollar, persisted in some of the nation's basic industries. Farmers continued to face less favorable export conditions than in much of the previous decade, land prices fell further, on average, and farm income remained depressed. As a result, farmers with large volumes of debt remaining from the late 1970s continue to face serious debt-servicing problems. The metals, agricultural implements, and some equipment industries also continue to face significant problems.

### U.S. Current Account\*

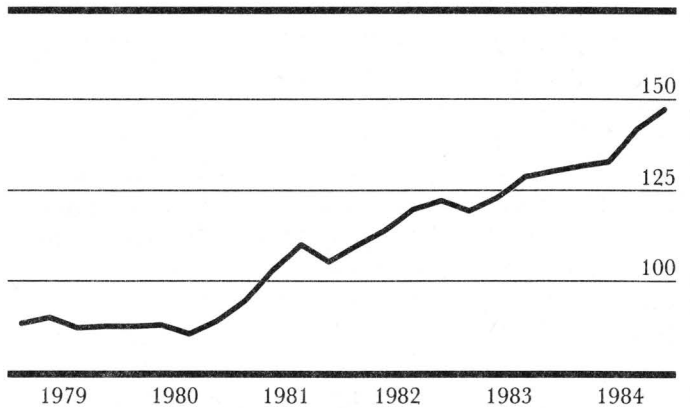
Billions of dollars



\*1984 is partially estimated.

### Exchange Value of the U.S. Dollar

Index, March 1973 = 100



### The Foreign Sector

The appreciation of the dollar over the last four years directly contributed to the imbalance between exports and imports in 1984. On a trade-weighted average basis, the dollar climbed a further 12 percent during the course of the year, bringing the cumulative appreciation since the end of 1980 to about 65 percent, and the rise has continued in 1985. Part of the dollar's strength in the first half of last year may have been generated by a widening of the differential between real interest rates in the United States and real rates abroad; however, the influence of this factor appears to have been reversed in the second half of the year. The relative dynamism of the U.S. economy and success in curbing inflation helped attract capital from abroad. Conversely, relatively slow economic growth elsewhere and economic and political uncertainties in various countries also may have contributed to the dollar's appreciation throughout the year. The current account deficit was about \$100 billion in 1984, compared to \$42 billion in 1983.

### Labor Market Developments

Developments in labor markets continued to be favorable during the second year of expansion. Reflecting the strength of activity and improved employment prospects, growth of the labor force

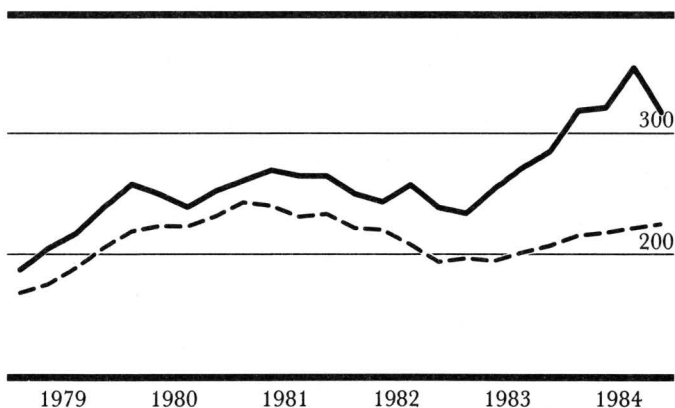
picked up last year. But the number of new jobs expanded even more rapidly, and the unemployment rate was 7.2 percent in the fourth quarter, more than a percentage point below the rate at the end of 1983. Indeed, since the recession low in late 1982, nonfarm payroll employment has increased by nearly 7 million, the largest two-year gain in three decades.

Wage developments in 1984 were more favorable to the control of inflation; even though labor market slack was reduced substantially further during the year, wage rates increased less than in 1983. The employment cost index, a comprehensive measure of change in wages and benefits, rose just 4 percent in 1984, nearly one percentage point less than the year earlier. Moreover, major collective bargaining agreements during the year showed no acceleration in nominal wage rates, even in those industries with improved economic conditions.

Over the course of the year, labor productivity increased 2 1/4 percent, partly reflecting a cyclical adjustment to higher levels of output as well as apparently some improvement in the underlying trend rate of growth from the very low pace of the 1970s.

## U.S. Merchandise Trade

Billions of dollars



## Footnotes

1. **M1** is currency held by the public, plus travelers' checks, plus demand deposits, plus other checkable deposits (including negotiable order of withdrawal (NOW and Super NOW) accounts, automatic transfer service (ATS) accounts, and credit union share draft accounts).

**M2** is M1 plus savings and small denomination time deposits, plus Money Market Deposit Accounts, plus shares in money market mutual funds (other than those restricted to institutional investors), plus overnight repurchase agreements and certain overnight Eurodollar deposits.

**M3** is M2 plus large time deposits, plus large denomination term repurchase agreements, plus shares in money market mutual funds restricted to institutional investors and certain term Eurodollar deposits.

**Total Domestic Nonfinancial Sector Debt** is outstanding debt of domestic governmental units (federal, state and local), households, and nonfinancial businesses.

2. Ranges for the aggregates and "Actual" figures for 1984 are measured from fourth quarter 1983 to fourth quarter 1984. The figures for the monetary aggregates are based on recent benchmark and seasonal adjustment revisions. Before those revisions, the 1984 increases were measured at 5.0 percent for M1, 7.5 percent for M2, and 10.0 percent for M3.

3. M1, M2, and M3 incorporate effects of benchmark and seasonal adjustment revisions.

4. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

A copy of the full report to Congress is available from Publication Services, Federal Reserve Board, Washington, D.C. 20551