

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

Monetary Policy Objectives for 1985

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Midyear Review of the Federal Reserve Board of Governors
System

July 17, 1985

Monetary Policy Objectives for 1985

With Tentative Monetary Growth Ranges for 1986

Summary of Report to the Congress on Monetary Policy pursuant
to the Full Employment and Balanced Growth Act of 1978.
July 17, 1985

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Monetary Policy in 1985 and 1986

The fundamental objective of the Federal Reserve in charting a course for monetary and debt expansion remains unchanged—to foster a financial environment conducive to sustained growth of the economy, consistent with progress over time toward price stability. In working toward those goals, developments with respect to the dollar and our external position have necessarily assumed greater prominence. More generally, while policy initiatives are stated in terms of growth rates of certain monetary and credit aggregates, the Federal Open Market Committee has emphasized the need to interpret those aggregates in the light of other information about the economy, prices, and financial markets. Moreover, the monetary targets for 1985 needed to be evaluated, and in the case of M1 adjusted, in light of the unusual and unexpected behavior of GNP relative to money during the first half of this year.

Growth ranges for 1985 and 1986 selected by the FOMC at its July meeting are shown in the table below.

Growth Ranges for 1985 and 1986

In reexamining its M1 range for 1985, and in setting a tentative range for 1986, the FOMC expected that velocity (the rate of nominal GNP to money), after its sharp decline in the first half of the year, would cease falling rapidly—while recognizing that much of the recent decline may not be reversed. Allowance also needed to be made for the high degree of uncertainty surrounding the behavior of M1 velocity, given the experience of the past few years. To take account of these considerations, the base for the range of M1 was shifted forward to the second quarter of 1985 and the range was set to encompass growth at a 3 to 8 percent annual rate over the second half of this year. This range contemplates a substantial slowing in growth from the pace of the first half, and the lower part of the range implies a willingness to see relatively slow growth should the recent velocity decline be reversed and economic growth be satisfactory.

The appropriateness of the new range will continue to be reexamined in light of evidence with respect to economic and financial developments, including conditions in foreign exchange markets. It was noted that, because of the burst of money growth in June, the current level of M1 is high relative to the new range. The Committee expected that the aggregate would move into the new range gradually over time as more usual behavior of velocity emerged.

Ranges of Monetary Growth 1985 and 1986¹

	1985 ² Ranges set in February	1985 ² Ranges set in July	1986 Tentative ²	1985 Actual QIV 1984 to QII 1985 ³
	Percent	Percent	Percent	Percent
M1	4 to 7	3 to 8*	4 to 7	10.5
M2	6 to 9	6 to 9	6 to 9	8.8
M3	6 to 9½	6 to 9½	6 to 9	7.9
Total Domestic Nonfinancial Sector Debt	9 to 12	9 to 12	8 to 11	12.8 ⁴

¹Annual rate of growth from the second quarter to fourth quarter 1985.

The Committee recognized that uncertainties about interest rates and other factors that could affect velocity would require careful reappraisal at the beginning of the year of the M1 range for 1986 of 4 to 7 percent. In addition, it was noted that actual experience with institutional and depositor behavior after the completion of deposit rate deregulation early next year would need to be taken into account in judging the appropriateness of the ranges. At the beginning of next year, regulatory minimum balance requirements on "Super-NOW" accounts and money market deposit accounts will be removed, and at the end of March 1986, deposit ceiling rates will be lifted entirely, affecting savings deposits and regular NOW accounts.

For 1985, with respect to the broader monetary and credit aggregates, the Committee reaffirmed the ranges selected in February. It is recognized, as at the start of the year, that actual growth over the four quarters of 1985 might tend toward the upper parts of the ranges, and it was felt that this would be acceptable, depending on developments in the velocities of the various measures, as long as inflationary pressures remained subdued.

For 1986, the tentative range for M2 was left unchanged. The tentative ranges for M3 and total debt embody reductions from 1985. In the case of the monitoring range for debt, it was assumed that, while debt might well continue its tendency of recent years to grow considerably faster than GNP, its expansion would be tempered by a drop-off in the net redemption of equity shares that has boosted corporate credit use dramatically in the past year or two.

Economic Projections

All the monetary ranges specified were felt to be consistent with somewhat more rapid economic growth than characterized the first half of the year, as long as inflationary pressures remain contained. At the same time, Committee members felt that the present circumstances in the economy contain particular risks and uncertainties that can imperil progress over the next year and a half toward either growth or price stability. Clearly, the serious imbalances in the economy cannot be remedied through the actions of the central bank alone. Attainment of fully satisfactory economic performance and minimization of risks will require timely action in other areas of policy, here and abroad. The economic projections of the members of the FOMC (as well as of the Reserve Bank presidents who are not at present members) are shown in the table on the next page.

The projections for a pick-up in GNP growth over the reduced rate of the first half of this year are based in part on the expectation that the declines in interest rates (and concomitant rise in stock prices) that have occurred over the past few quarters will be providing impetus to demand for goods and services in the months ahead. Consumer attitudes toward spending appear favorable, and housing activity already has shown improvement, although FOMC members are somewhat concerned about the rising debt burdens of households and the increasing payment problems suggested by consumer and mortgage loan delinquencies.

In the business sector, inventory overhangs appear to be limited in scope and degree, and fixed investment seems to have picked up a little after exhibiting some weakness earlier this year; the lower cost of capital and desires to cut costs and maintain competitiveness are expected to keep investment on a moderate uptrend, even though pressures on capacity may not be great. Spending by the federal government and by states and localities is expected to grow rather slowly.

A key ingredient in many of the projections is the expectation that there will be a tendency in the coming year for our external position to stabilize, so that domestic production will more fully reflect the expansion of domestic demand. Developments in this area will, of course, depend in part on the course of economic expansion abroad. Were the U.S. external position to continue to deteriorate as it has, the sectoral imbalances in the economy would be exacerbated, creating further difficulties for many companies, their employees and communities. The draining off of income would jeopardize the sustainability of economic expansion, and the risks of economic and financial dislocations would intensify.

The FOMC members and other presidents also assumed that the Congress and the Administration would achieve deficit reductions in the range of those in the recent House and Senate budget resolutions. Failure to move forward with those proposals would mean a serious risk of reversing the favorable effects that congressional actions to date have had on investor expectations and would create a real impediment to the solution of the structural problems plaguing our economy today.

Economic Projections for 1985 and 1986

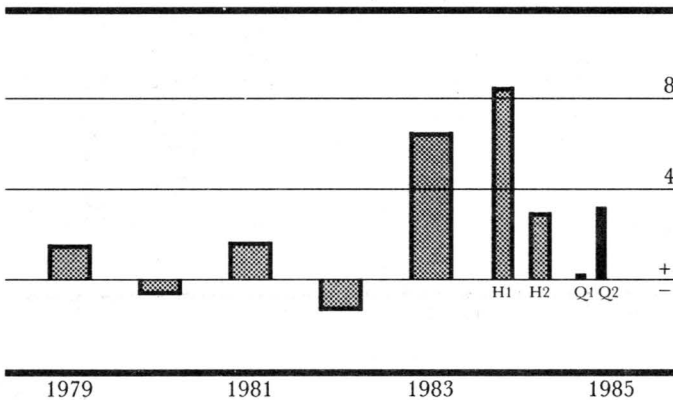
		FOMC members and other FRB Presidents ⁵	
1985		Range	Central Tendency
Change, fourth quarter to fourth quarter:	Nominal GNP	6¼ to 7¼	6½ to 7
	Real GNP	2¼ to 3¼	2¾ to 3
	Implicit deflator for GNP	3½ to 4¼	3¾ to 4
Average level in the fourth quarter:	Unemployment Rate	6¾ to 7¼	7 to 7¼
1986		Range	Central Tendency
Change, fourth quarter to fourth quarter:	Nominal GNP	5½ to 8½	7 to 7½
	Real GNP	2 to 4	2½ to 3¼
	Implicit deflator for GNP	3 to 5½	3¾ to 4¾
Average level in the fourth quarter:	Unemployment rate	6¾ to 7½	6¾ to 7¼

Review of Economic and Financial Background

Economic activity continued to expand during the first half of 1985, but at a relatively slow pace. Real gross national product increased at an annual rate of about 1 percent, falling short of the expectations of many forecasters and of the rate anticipated for the year by members of the Federal Open Market Committee when they formulated their annual monetary policy plans in February. While the economic environment was conducive to the containment of inflation within the 3½ to 4 percent range of the past few years, there has been no further progress toward full employment of the nation's labor resources or industrial capacity. Indeed, the unemployment rate has remained at about 7¼ percent, well below the peak of the 1981-82 recession, but still an historically high level.

Real GNP

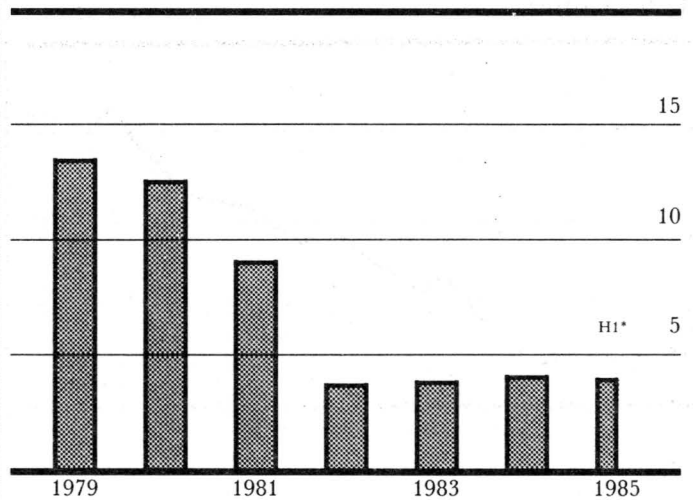
Change from end of previous period,
annual rate, percent



The slowing of output growth, which began in the middle of 1984, has brought into sharper focus the unevenness of this business expansion and the significance of some basic structural imbalances in the economy. The federal budget deficit has

Consumer Price Index

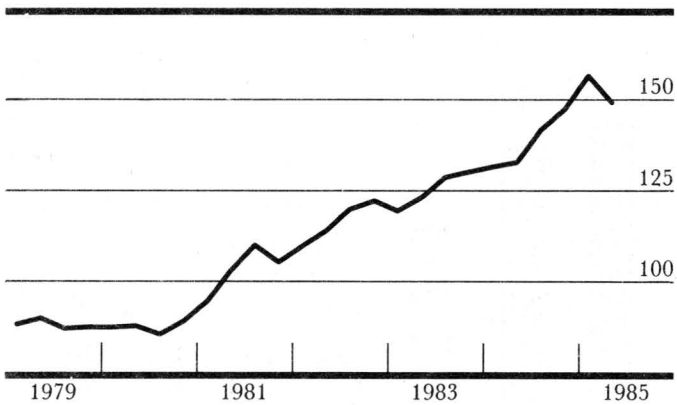
Change from end of previous period,
annual rate, percent



remained in the neighborhood of \$200 billion, rather than moving in the direction of balance as might normally be expected in the course of an upswing in economic activity. The heavy demands placed on the credit markets by the Treasury's financing activities have, in turn, been one factor helping to hold real interest rates at historically high levels. And those high rates have contributed to the strong demand of international investors for dollar-denominated assets and thus to the strength of the dollar on foreign exchange markets.

Exchange Value of the U.S. Dollar

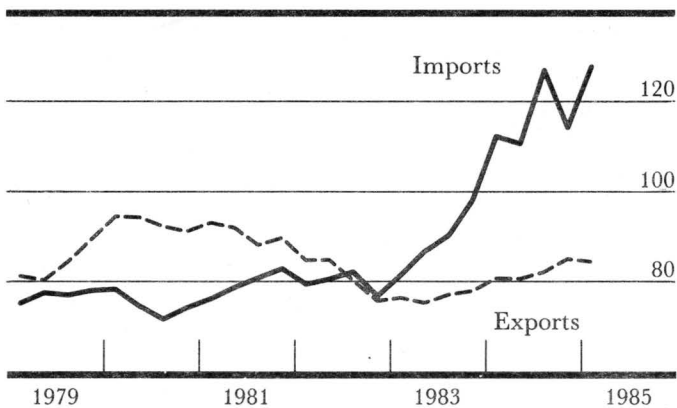
Index, March 1973 = 100



Although the dollar was little changed on balance over the first half, with a spike in its value early in the year being subsequently reversed, the adverse effects on the U.S. trade position of the appreciation of the preceding several years, together with slow economic growth abroad, were very much in evidence. U.S. firms continued to face severe competitive pressures, and our exports fell while our imports rose. The widening current account deficit was mirrored in the continuing gap between the growth of domestic spending and domestic production. Moreover, the effects of this imbalance were

U.S. Real Merchandise Trade

Billions of 1972 dollars

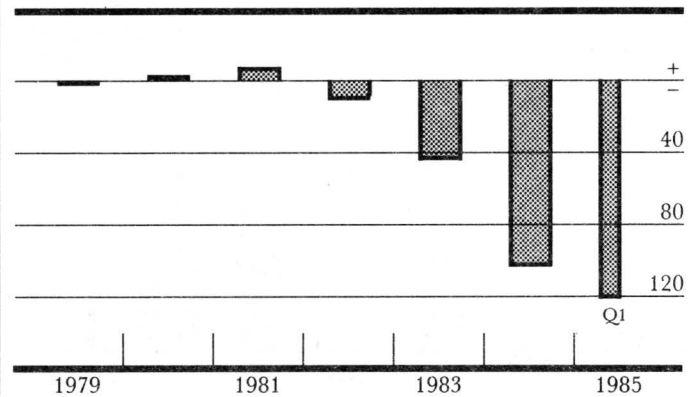


felt with particular severity in the manufacturing, mining, and agricultural sectors of the economy, where profitability was squeezed overall and employment declined.

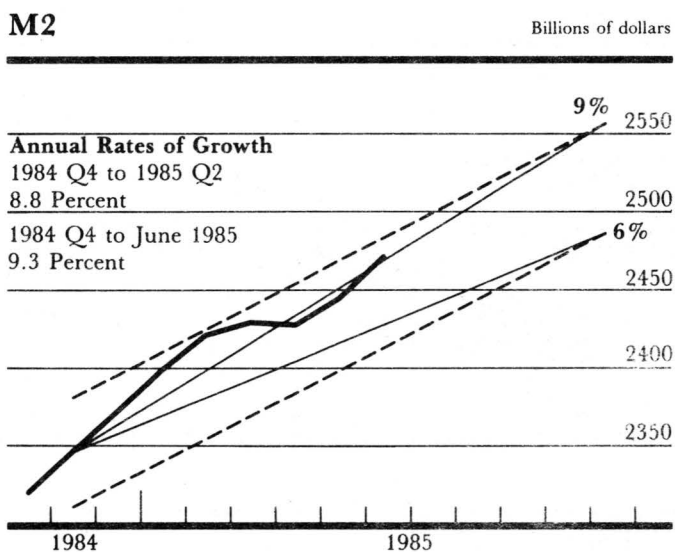
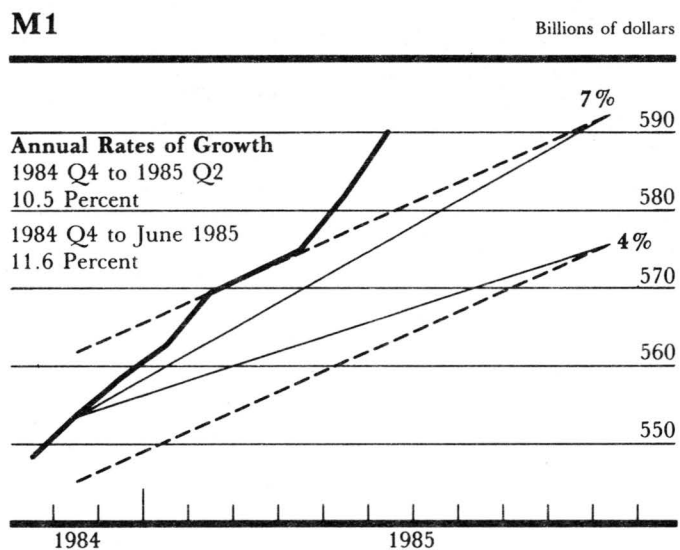
The lagging growth of production, relatively well contained inflationary pressures on resources, and the high value of the dollar on exchange markets provided the backdrop for the conduct of monetary policy in the past several months. Reserves available to the banking system expanded substantially over the first half of the year, and the discount rate was cut by 1/2 percent in the spring. With the economic expansion slowing, interest rates—which had declined sharply from the summer of 1984 to early 1985—dropped somewhat further on balance by mid-year.

U.S. Current Account

Billions of dollars



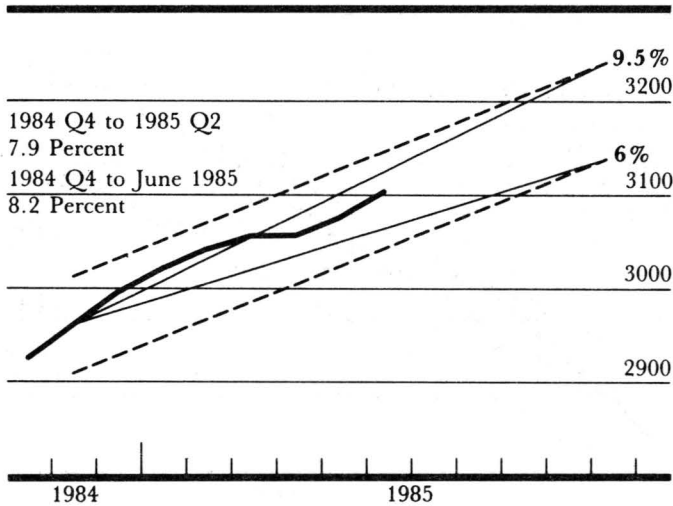
The declines in market interest rate in the latter part of last year and this year had substantial effects, lasting for a number of months, on the demands for assets contained in M1. Some savings apparently were shifted into interest-earning checking accounts (NOW accounts) from other instruments, and demand deposits also rose, as the cost of holding these accounts in terms of earnings forgone was reduced. As a result of the shifts of funds, M1 expanded at a rate well above the 4 to 7 percent rate established in February. At the same time, however, the broader monetary aggregates remained within their designated ranges.



The rapid growth of M1 in the first half of the year was accompanied by a sharp drop in the velocity of the aggregate: M1 velocity—the rate of nominal GNP to money—declined at about a 5 percent annual rate. The recent developments affecting M1 illustrate the still considerable uncertainties about the shorter-run behavior and trend of its velocity.

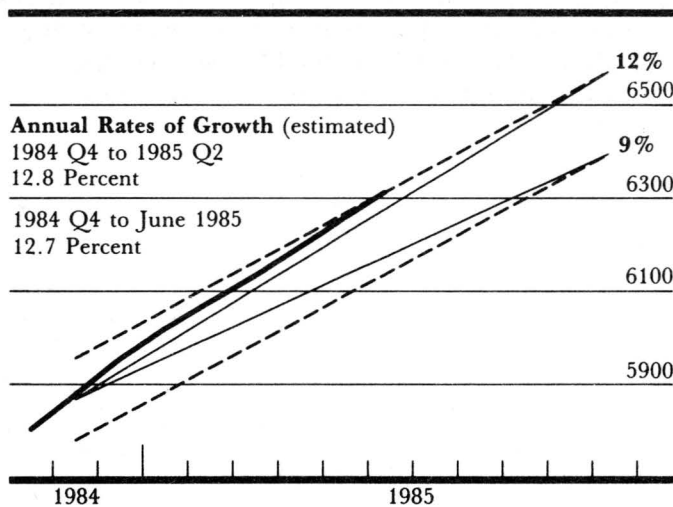
M3

Billions of dollars



Domestic Nonfinancial Sector Debt

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. Except for the M1 range for 1985 set in July, growth ranges are measured from fourth quarter to fourth quarter.

3. Measured from fourth quarter 1984 to June 1985, actual figures are: M1, 11.6 percent; M2, 9.3 percent; M3, 8.2 percent; debt, 12.7 percent (estimated).

4. Estimated.

5. Administration budget documents were not available at publication.

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