

Federal Reserve System - Monetary Policy Report [1986]



Monetary Policy Objectives for 1986

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Summary Report of the Federal Reserve Board

February 19, 1986

Monetary Policy Objectives for 1986

Summary of Report to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978. February 19, 1986.

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Monetary Policy and the Economic Outlook for 1986

While there are unusual uncertainties surrounding prospects for prices and economic activity in 1986—stemming in part from questions about the timing and dimension of domestic adjustments to the weaker dollar on exchange markets, oil price declines, and the process of fiscal restraint—the overall economic outlook for the year appears generally favorable. Real economic growth probably will pick up somewhat from last year's pace, and inflationary pressures should remain contained. The recent weakness in oil prices, though it has the potential for causing dislocations in energy markets and adding to the strains on some heavily indebted oil-producing countries, should enhance real growth and work to offset the upward impact on the price level this year from the drop in the dollar on exchange markets. Over the course of the year, the prospective movement toward fiscal restraint, and also the more competitive exchange rate, should help correct imbalances that in recent years have threatened the sustainability of economic expansion and affected domestic and international financial markets.

Monetary Policy for 1986

At its February meeting, the Federal Open Market Committee framed its monetary policy plans for 1986 in light of the fundamental objectives of maintaining sustainable growth of economic activity, making continued progress over time toward price stability, and working toward better balance in the nation's external transactions. Ranges set by the FOMC for the monetary aggregates and a monitoring range for debt are

Ranges of Monetary Growth 1986¹

Measured from fourth quarter 1985 to fourth quarter 1986

M1	3 to 8 percent
M2	6 to 9 percent
M3	6 to 9 percent
Total Domestic Nonfinancial Debt	8 to 11 percent

shown above. These ranges are the same as those for 1986 tentatively set last July, except that the M1 range has been widened to reflect the uncertainties affecting the behavior of that aggregate.

In particular, the availability of interest-bearing checking accounts that serve both transaction and savings functions may have increased the sensitivity of M1 to changes in market rates as well as to other factors influencing the public's allocation of its savings among various financial assets. While the range for M1 is wide enough to allow for some variation in behavior of the aggregate's income velocity in response to changing conditions, the range was set on the assumption that there would not be a large drop in velocity, such as occurred in 1985. In that connection, the Committee will evaluate behavior of M1 in light of its consistency with the other monetary aggregates, economic and financial developments, and the potential for inflationary pressures. In sum, policy implementation will involve continuing appraisal of the relationships among the various measures of money and credit, their velocity trends, indicators of economic activity and prices, as well as conditions in domestic credit and foreign exchange markets.

The growth of the broader aggregates in 1986 is not expected to be far different from last year, when

their velocities declined somewhat. Last year's velocity experience was closer to the norm for these aggregates than was the case for M1. The final phase of deposit deregulation this year—the removal of minimum balance requirements on money market deposit accounts at the beginning of the year and the elimination of ceiling rates on savings and regular NOW accounts at the end of March—is expected to have only minimal effects on the broad aggregates as well as on M1.

The Committee for some years has had a monitoring range for the total debt of domestic non-financial sectors. Historically, debt has expanded about as rapidly as GNP, but in recent years debt has grown more rapidly than the economy, raising some concern about the increasing debt burden. The growth of debt is expected to moderate somewhat in 1986. While the federal deficit is expected to remain at a high level for much of 1986, it should begin declining in the course of the year as greater fiscal restraint takes hold and helps to curb the rate of increase in U.S. government debt.

Economic Projections

The FOMC felt that its monetary objectives were consistent with expectations for continued growth in output, further reductions in unemployment, and muted inflation in 1986. While there clearly are a

good many uncertainties and risks in the present environment—for instance, the actual outcome for the budget, the behavior of the dollar, and oil prices—the Committee members and other Reserve Bank Presidents generally believe that prospects for the economy in the year ahead are reasonably favorable, and their projections are indicated in the table below.

The expanding job opportunities associated with the increase in output are expected to lower the unemployment rate gradually, although sluggish productivity performance, if it should continue, would limit the nation's growth potential.

Two key factors in the positive economic outlook are the recent developments in energy and financial markets. The decline in energy prices should raise the growth of real disposable income and bolster consumer spending in the months ahead. The marked increase in household financial wealth associated with the substantial rise in stock and bond prices also should provide the basis for continued gains in consumer outlays. This should work to offset the restraint in spending that could be exerted by the runup in household indebtedness and the associated decline in the personal saving rate during the past

Economic Projections for 1986 (percent)

		FOMC members and other FRB Presidents		Administration	CBO
		Range	Central Tendency		
Change, fourth quarter to fourth quarter:	Nominal GNP	5 to 8½	6½ to 7¼	8.0	7.6
	Real GNP	2¾ to 4¼	3 to 3½	4.0	3.6
	Implicit deflator for GNP	2½ to 4½	3 to 4	3.8	3.9
Average level in the fourth quarter:	Unemployment Rate	6¼ to 6¾	About 6½	6.7	6.7*

*Civilian unemployment rate.

year. Notwithstanding the increase in household wealth, the level of consumer debt remains a risk to the outlook for consumer spending.

The rise in stock prices and decline in interest rates has improved prospects for domestic investment in plant, equipment, and housing. While the federal deficit is not likely to drop significantly for some months, greater fiscal restraint, as it develops, should enhance the availability of domestic savings for private investment and reduce the need to rely on foreign saving. Mortgage rates are currently at their lowest levels since 1979, and the greater affordability of housing can be expected to buoy residential construction in the face of some evident overbuilding in the multifamily sector. Similarly, lower costs of capital—along with some improvement in the competitiveness of U.S. industry owing to the dollar's decline—help to support business investment despite likely weakness in the energy and office building sectors. In the near term, the leanness of manufacturers' inventories suggests the likelihood of some pickup in the rate of inventory accumulation.

The outlook for the external sector is quite uncertain. The response of U.S. industry, as well as foreign producers, to the decline in the dollar will take place only over time and will depend on a number of factors, such as the extent to which it is believed the exchange rate change is "permanent" and on

the strategies firms pursue with respect to the potential trade-off between profit margin and market share. Perhaps more important in the short run, our trade and current account positions also will depend on the pace of economic growth abroad; if growth in other countries is relatively slow, that would tend to limit near-term improvement.

With regard to the outlook for inflation, wages in the aggregate have shown no tendency toward acceleration and recent settlements in major collective bargaining agreements indicate wage gains in manufacturing, construction, and transportation are likely to continue at the moderate pace registered in recent years, even though the unemployment rate is declining. Disappointing productivity performance does raise questions about pressures from the labor cost side, although some pickup in productivity improvement is assumed this year. A decline in oil prices also should be a constructive influence. Nevertheless, it was recognized that a weaker dollar poses a clear risk of greater inflationary pressures.

Monetary Policy and the Performance of the Economy in 1985

Monetary Policy in 1985

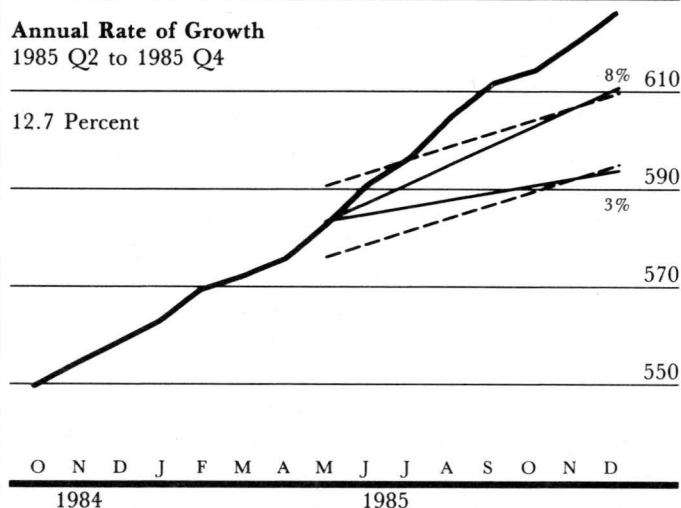
In July, the FOMC reaffirmed the ranges set in February for M2, M3, and debt, but established a new M1 growth range of 3 to 8 percent, measured at an annual rate, from the second to the fourth quarter of the year. The M1 objective anticipated a considerable slowing of money growth in the second half of the year, on the assumption that more normal historical behavior in the velocity of M1 would re-emerge. Continued uncertainty about the behavior of the aggregate, however, was signaled in widening the M1 range by 2 percentage points.

The unusual pattern of M1 behavior in fact persisted over the second half of the year; growth in the aggregate did not slow, and its velocity registered an even steeper decline. At the same time, the broader monetary aggregates were growing generally within their ranges, while economic growth had slowed to well below the pace of the year before and upward price pressures remained muted. In the fall, the FOMC determined that, under these circumstances, growth in M1 above its range for the second half of the year would be acceptable.

In general, the FOMC last year emphasized the need to evaluate growth in all the aggregates in light of developments in the economy and prices, as well as conditions in financial and foreign exchange markets. Throughout the year, monetary policy remained generally accommodative to emerging demands for money. Pressures on bank reserve posi-

M1

Billions of dollars



tions were varied in a narrow range over the year, and the discount rate was reduced once, by one-half percentage point. Much of the unusually strong growth in M1 in 1985 and the accompanying decline in velocity seemed to be attributable to lower interest rates, though expansion in the aggregate was stronger, particularly in the second half of the year, than historical evidence on its relationship to income and interest rates would have suggested. The

Growth of Aggregates 1985²

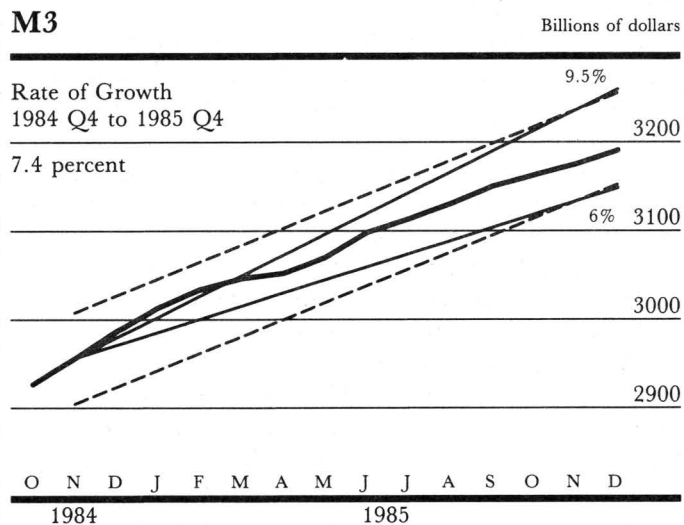
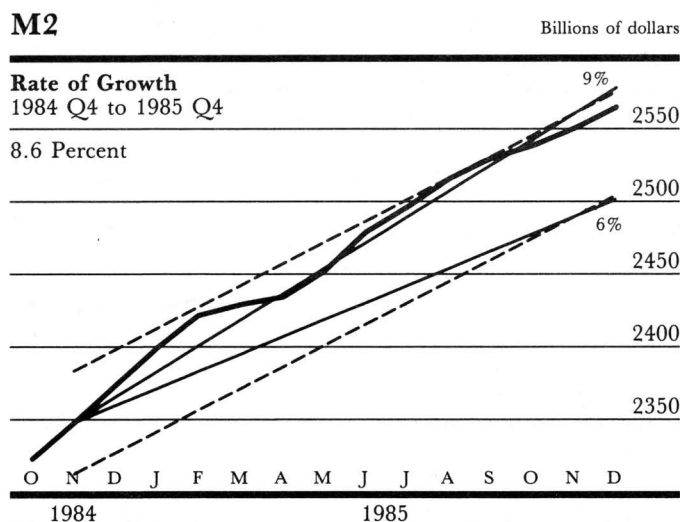
	1985 Range	1985 Actual	1985 Q4 Levels*
M1	3 to 8 percent**	12.7 percent**	620.1
M2	6 to 9 percent	8.6 percent	2550.5
M3	6 to 9½ percent	7.4 percent	3176.5
Total Domestic Nonfinancial Debt	9-12 percent	13.5 percent	6637.5

*Billions of dollars seasonally adjusted

**Annual rate QII to QIV 1985

behavior of this aggregate may have become more sensitive to changes in market rates in recent years owing to the deregulation of certain transaction accounts. By reducing the opportunity cost of holding transaction balances, the creation of NOW and Super NOW accounts has made M1 a much more attractive savings vehicle for households. Moreover, with the rates on NOW accounts fixed and those on Super NOWs being adjusted sluggishly to changing conditions, falling interest rates have led to relatively substantial reductions in incentives to economize on M1 balances, with accompanying declines in velocity. However, considerable uncertainty about the response of M1 to variations in interest rates or income unavoidably persists, as both money holders and depository institutions adapt to the elimination of important regulatory constraints.

In 1985, the interaction of lower market interest rates with deregulated transaction deposit rates seemed to induce especially heavy inflows to interest-bearing checkable accounts. Spreads between



offering rates on these deposits and interest rates on time deposits and market instruments, low by the standards of recent decades, apparently diminished the incentives to keep savings in longer-term instruments, as well as to separate savings from transaction balances. Demand deposits also contributed to the increase in M1 last year, registering unusually rapid growth, especially in the second half. Business demand balances paced the rise, likely reflecting the cumulative effect of lower interest rates on incentives to economize on demand deposits and on compensating balance requirements, as well as generally more cautious cash management practices, possibly in part because banks and corporations sought to reduce risk in response to financial problems that had developed in certain areas of the market.

Financial Markets

At mid-year most market interest rates had fallen about 3 to 4 percentage points below their mid-1984 levels. On balance over the second half of 1985, most short-term interest rates were little changed, ending the year just slightly above their midyear lows and about a percentage point below their levels when 1985 began. However, on exchange markets, the dollar declined more than 15 percent over the second half, impelled in large part by the G-5 announcement in September indicating the desirability of some appreciation of other currencies relative to the dollar and by the ensuing coordinated intervention by the United States and other key industrial countries.

In long-term debt markets, interest rates generally fell a percentage point or more on balance over the second half, with most of the decline occurring during the fourth-quarter rally that accelerated as the year drew to a close. The downward movement in

long-term rates, and simultaneous surge in stock market prices, was fueled in part by legislative initiatives to mandate reductions in the federal deficit and pare the government's demands on credit markets.

Early in the year, privately insured savings and loans in Ohio, and then in Maryland, were closed or limited to small withdrawals following depositor runs in both states. As the difficulties emerged, the Federal Reserve advanced funds at the discount window to the affected institutions to bolster their liquidity. Such lending—whose expansive reserve effect was offset through open market operations—has been repaid in Ohio, where the troubled institutions have been restructured and reopened, but remains outstanding at a number of Maryland thrift institutions.

The thrift industry as a whole showed some improvement in earnings and capital positions last

Growth of Money and Credit (Percentage changes)³

Period		M1	M2	M3	Domestic Nonfinancial Debt
Fourth quarter to fourth quarter	1979	7.5	8.1	10.3	12.4
	1980	7.3	9.0	9.6	9.6
	1981	5.2 (2.5) ⁴	9.3	12.3	9.8
	1982	8.7	9.1	10.0	9.1
	1983	10.4	12.2	9.9	11.2
	1984	5.4	8.0	10.5	14.1
	1985	11.9	8.6	7.4	13.5
Quarterly growth rates 1985	Q1	10.1	11.7	10.1	13.5
	Q2	10.5	6.3	5.6	11.9
	Q3	14.5	9.5	7.6	12.2
	Q4	10.6	5.9	5.7	13.7

year, although many institutions remained heavily burdened with low quality or low yielding assets. Lower interest rates lifted profits from their depressed 1984 levels by reducing the cost of funds and generating capital gains on asset sales. The profitability of commercial banks also appears to have increased in 1985, breaking the downtrend of recent years. Asset quality remained a concern for some institutions, however, and was a major factor in the sharp increase in the number of bank failures. Banks apparently again increased the rates at which they charged off bad loans and added to loan-loss reserves, reflecting continued financial strains in such industries as agriculture, energy and real estate. Higher profits along with the rallies in stock and bond markets helped many banks improve their capital positions in 1985, facilitating efforts to comply with more stringent capital adequacy guidelines. As part of its efforts to ensure the continued safety and soundness of the financial system, the Federal Reserve also initiated a program to strengthen supervision of commercial banking operations.

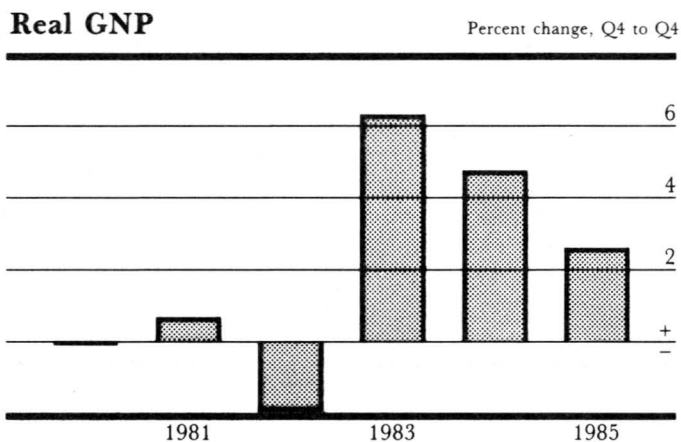
Agricultural finances drew special attention last year. Farm income remained depressed, and falling prices for agricultural products left many farmers unable to meet their debt-servicing requirements. Moreover, declining land prices eroded the value of collateral behind many agricultural loans. Consequently, failures of banks with relatively high proportions of agricultural loans in their portfolios rose to 68 in 1985, from 32 in 1984 and an average of just 6 in each of the preceding three years.

To ease possible constraints on the availability of credit at agricultural banks over the 1985 growing season, the Federal Reserve in March liberalized its regular seasonal borrowing program and initiated a

temporary special seasonal program aimed at making liquidity available to agricultural banks that might experience strong loan demand. Although total seasonal borrowing fell short of the unusually high level in 1984, evidence suggests that these actions increased access to seasonal credit, boosting borrowing somewhat above what would otherwise have been expected given money market conditions and overall slack loan demand by farmers. In early 1986, the Federal Reserve renewed the temporary seasonal program to assure that agricultural banks would not face liquidity constraints in accommodating the needs of their farm borrowers this year.

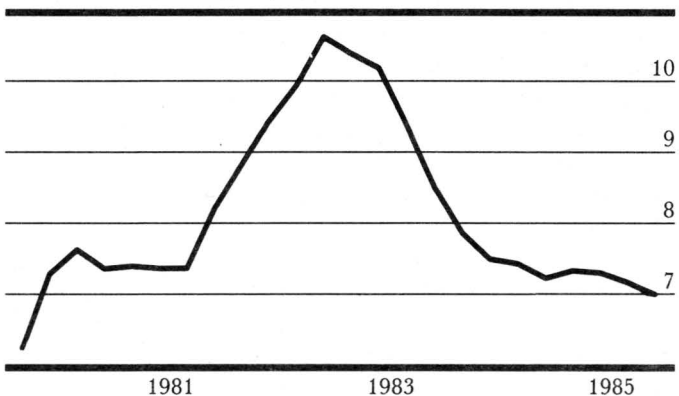
Economic Performance in 1985

The economy completed a third successive year of expansion in 1985, with real gross national product increasing 2½ percent over the year. The rise in economic activity was sufficient to create 3 million new payroll jobs, and the unemployment rate edged down; with a further strong increase in employment in January of this year, the jobless rate for civilians reached a six year low of 6.7 percent. Most broad measures of price increase indicate that inflation slowed to about a 3½ to 3¾ percent rate in 1985, somewhat less than the pace registered over the previous two years.



Civilian Unemployment Rate

Quarterly average, percent



Though output and employment continued to grow in 1985, the rate of expansion was slower than some had anticipated, raising concern about the sustainability of the recovery. Furthermore, the pattern of developments in the past year had some disturbing aspects: domestic and foreign demands continued to be diverted away from goods and services produced in the United States, draining income from our households and businesses and exacerbating an inventory correction by U.S. firms as their sales lagged. Consumers continued to increase their spending at a substantial clip, but only by borrowing at a pace that pushed household debt burdens to still higher levels.

Serious sectoral imbalances that had emerged earlier during the recovery became more apparent when gains in activity moderated. Industrial output grew slowly in 1985, and manufacturing and mining employment posted outright declines during much of the year. The agricultural sector remained under acute pressure, as shrinking export markets

and abundant harvests pushed prices sharply lower. As a result, farmers continued to face mounting difficulties in servicing the large volume of debt accumulated in the 1970s.

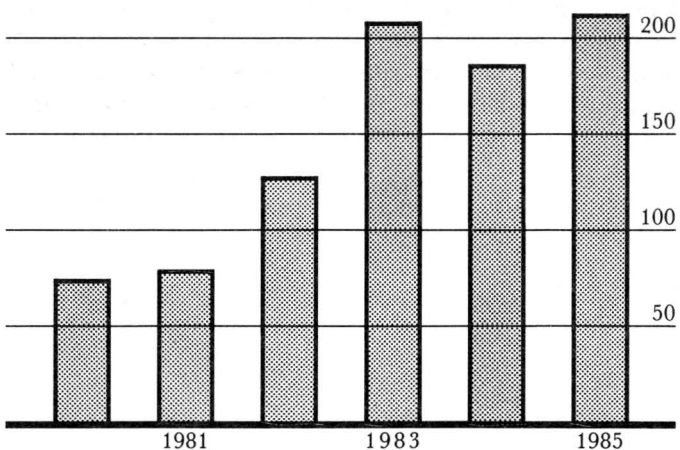
To a considerable extent, these imbalances and stresses are related to fundamental disequilibria in the nation's finances: the continuing huge federal budget deficit and the growing deterioration in the U.S. current account. During the past year, however, policymakers took important steps to address these problems. The Balanced Budget and Emergency Deficit Control Act was passed, establishing a mechanism for deficit reduction and signaling the resolve of Congress and the Administration to achieve meaningful progress on this front. And the financial authorities of the G-5 nations agreed that exchange rates should better reflect underlying economic relationships, which could enhance the prospects for some improvement in our external balance.

The federal budget deficit was of record magnitude in fiscal year 1985. The large federal deficit not only absorbed a significant portion of the savings

Federal Government Deficit

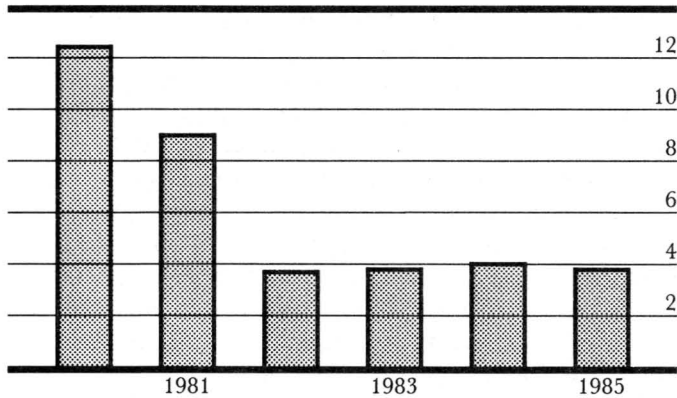
Billions of dollars

Fiscal Years



Consumer Price Index

Percent change,
December to December



available to the domestic economy, but also continued to be a source of concern to investors with respect to longer-range potential for inflationary pressures. Not surprisingly, the prospect for some reduction in the deficit contributed to the downward trend in interest rates late last year.

The importance of international economic developments for the performance of the U.S. economy has become increasingly apparent during the current economic expansion. Although the foreign exchange value of the dollar declined over most of the year—encouraged at times by coordinated official intervention activity—changes in spending patterns, which typically lag movements in exchange rates, were not yet evident, and imports made further inroads into domestic markets. Slow growth, on average, in much of the rest of the world

has failed to provide strong markets for U.S. exports. The net result has been that domestic demands have increased more rapidly than domestic production throughout the course of the expansion.

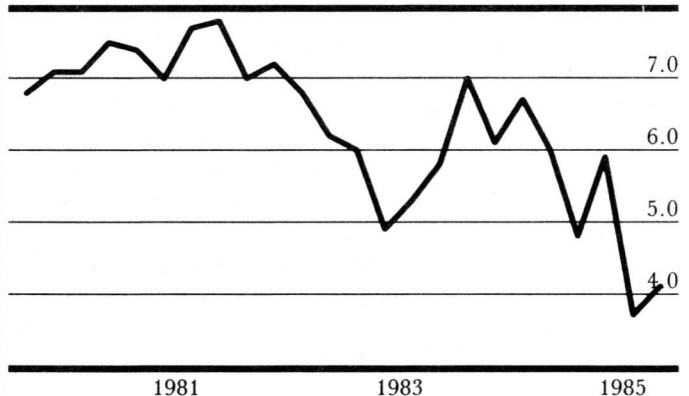
An important achievement of the current recovery has been the sustained expansion of economic activity with no relinquishment of the progress made toward the goal of price stability. The containment of inflation has been aided by the high exchange value of the dollar and excess world supplies of many basic materials, which have left prices unchanged or lower for a wide range of imported goods, industrial commodities, agricultural products and petroleum. More fundamentally, wage increases in the aggregate have been restrained, limiting upward pressures on costs.

The Household Sector

Spending in the household sector remained strong, despite a sharp slowing in income growth. Growth in real disposable income rose about 1½ percent in 1985, much less than the 4 percent increase of the previous year. Income growth was limited as wage and salary gains decelerated, interest income

Personal Saving Rate

Percent of disposable income



weakened and farm income plummeted. Real personal consumption expenditures advanced 3 percent last year—only a little less than in 1984—buoyed by continued high levels of borrowing. As a result, the personal saving rate fell to an average of about 4½ percent last year, well below historical norms.

Recent trends in consumer balance sheets continued last year. Consumer installment debt, which had climbed sharply in 1984, did so again in 1985, and the ratio of debt to disposable income reached a record high. Growth in financial assets of households has, however, more than kept pace with the rapid rise in debt over the past two years. In particular, the strong gains posted by the stock and bond markets in 1985 provided a substantial boost to household wealth.

Indications of debt-servicing difficulties in the household sector have mounted. Delinquency rates on consumer installment loans have been on the rise since mid-1984, and for some categories—such as bank credit cards—have reached relatively high levels. Moreover, mortgage loan delinquencies persist at the historically high levels that have prevailed since the 1981-82 recession. However, surveys of households continue to show favorable readings on attitudes concerning financial positions, suggesting these financial strains are currently limited to a small part of the population.

The Business Sector

Economic conditions in the business sector also were mixed last year. After-tax economic profits of non-financial corporations as a group increased sharply for a third consecutive year and as a percent of GNP stood at their highest level since the late 1960s. Many firms in manufacturing and mining industries, however, have encountered significant difficulties brought about by the high value of the dollar. In addition to the influence of the exchange rate, downward pressures on prices and profits in the agricultural and energy sectors have been exacerbated by ample supplies in world markets.

Business spending for equipment and structures advanced 6 percent in real terms in 1985. Neverthe-

less, the growth in business fixed investment was well below the extraordinary pace of the preceding two years.

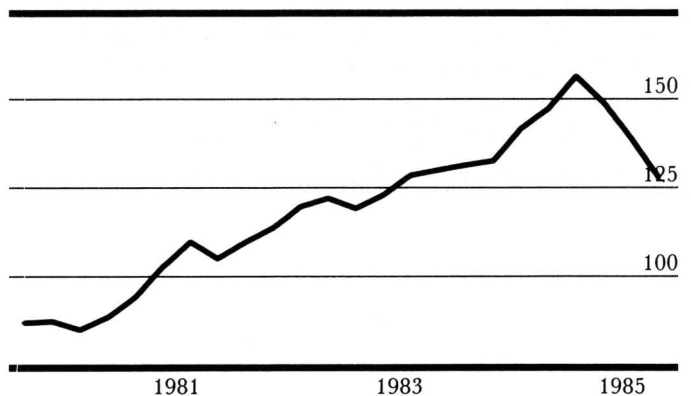
Businesses accumulated inventories at a much reduced pace in 1985, particularly in the manufacturing sector. In real terms, nonfarm business inventories rose \$10 billion last year, following the sharp \$56 billion investment that occurred in 1984. In the manufacturing sector, sluggish orders and stable or falling prices have induced businesses to adopt a cautious approach to inventory accumulation.

The Foreign Sector

After registering particularly sharp gains toward the end of 1984 and in the first two months of 1985, the dollar generally fell in international currency trading throughout the remainder of 1985. By the end of 1985 the trade-weighted foreign exchange value of the dollar had fallen nearly 25 percent from its peak in February. This decline occurred against the backdrop of a narrowing of the differential between inflation-adjusted long-term interest rates in the

Exchange Value of the U.S. Dollar

Index, March 1973 = 100



U.S. Real Merchandise Trade Billions of 1982 dollars



United States and other industrial countries, which at least in part reflected the slowing of economic growth in the United States relative to growth abroad.

It will take some time before the effects of the dollar's depreciation manifest themselves in the external position of the United States, which continued to deteriorate last year. The widening gap between imports and exports boosted the current account deficit to about \$120 billion, up from \$107 billion in 1984.

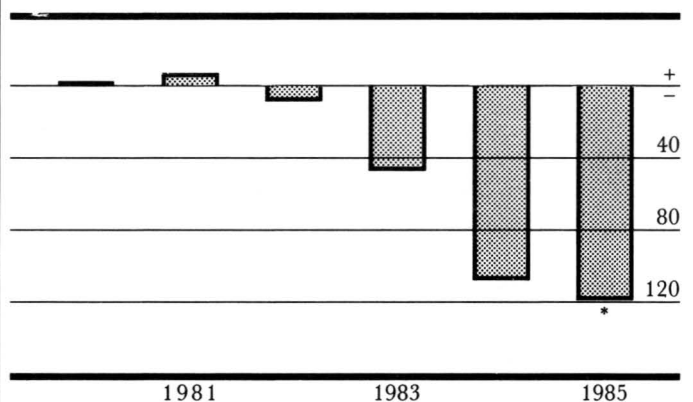
The Secretary of the Treasury in October urged the borrowing countries to undertake comprehensive programs of economic adjustment designed to promote efficiency and economic growth. At the same time, he called upon the international banking community, the World Bank and the other multilateral

development banks, working with the International Monetary Fund, to provide the assurance that adequate external financing would be available to support such programs during the next several years. The initial response to these proposals has been positive; all parties generally accept that they represent a constructive framework for dealing with individual countries' international debt problems and for promoting the growth and stability of the world economy.

Price Developments

Most broad measures of prices indicate that inflation was unchanged or perhaps moved a bit lower in 1985, even as the economy was passing through a third year of expanding activity. Progress toward price stability has been sustained by several factors, the most important of which have been subdued inflation expectations, moderate wage increases, and the influence of the high value of the dollar on the prices of imports and goods that compete with imports. In addition, developments in the food and energy markets continued to restrain the overall rate of inflation in 1985.

U.S. Current Account Billions of dollars



*Estimated.

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 **M1**, growth rates and actual figures are measured fourth quarter to fourth quarter; **M1**, measured fourth quarter to fourth quarter, is 11.9 percent.

3. **M1**, **M2**, and **M3** incorporate effects of benchmark and seasonal adjustment revisions made in February 1986.

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