

Federal Reserve System - Monetary Policy Report

Monetary Policy Objectives for 1986

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Midyear Review of the Federal Reserve Board

July 18, 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. July 18, 1986.

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Monetary Policy in 1986 and 1987

Sharp contrasts among sectors and regions of the economy characterized economic developments during the first half of 1986. Because of strong competitive pressures from abroad and large spending cut-backs in the oil industry in response to sharply declining prices, industrial and investment activity were restrained. In contrast, activity continued to expand rather strongly in housing, the financial sector, and the broad service area of the economy.

Although there are substantial uncertainties about the degree and timing of a pickup in overall economic activity, a number of positive economic and financial developments have occurred that should provide the basis for somewhat faster economic growth and some reduction in unemployment over the year ahead. Interest rates have moved lower, and, reflecting the decline of the dollar on foreign exchange markets, U.S. industry is in a stronger competitive position internationally. In addition, inflation has remained subdued, reflecting not only declines in the prices of energy and other basic commodities but also continued restraint on wages in many sectors. Much of the uncertainty about a pickup in growth turns on the strength of economic performance in other industrialized countries, and there also is some concern over the transitional effects of tax reform legislation.

A reduction of the large deficit in the nation's external accounts is of critical importance over time, and this will be difficult to achieve in an orderly way without faster growth in key foreign economies.

Agreement on tax reform also would remove a major source of uncertainty that probably has inhibited growth in the first half of the year. In addition, substantial progress toward eliminating federal budget deficits is essential to achieving better balance in the U.S. and world economies. Overall, prospects for the economy appear to be favorable, but much will depend on the evolution of policy, both in this country and abroad.

Growth of Money and Debt in 1986 and 1987

The Federal Open Market Committee (FOMC) reaffirmed the 1986 target ranges of 6 to 9 percent that had been established in February for growth in the broad money measures—M2 and M3.

For 1987, the Committee decided that the target growth ranges for both M2 and M3 would be

Ranges of Growth for Monetary and Debt Aggregates¹ (Percent Change)

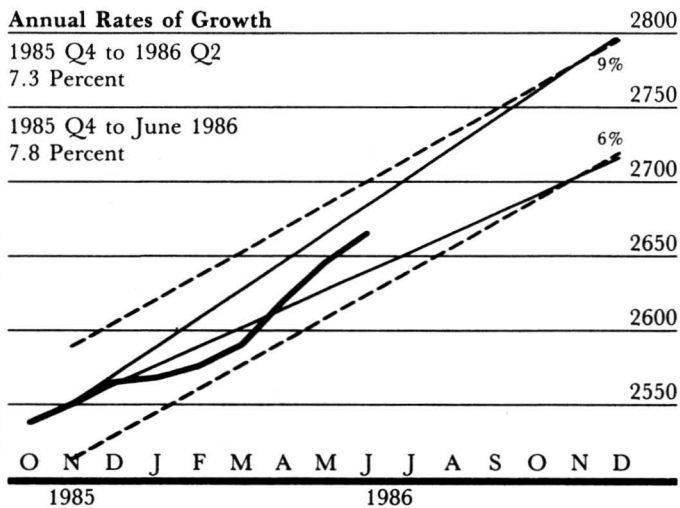
	1986	Tentative for 1987
	1985 Q4 to 1986 Q4	1986 Q4 to 1987 Q4
M1	(3 to 8)*	(3 to 8)**
M2	6 to 9	5½ to 8½
M3	6 to 9	5½ to 8½
Debt	8 to 11	8 to 11

*While no new range was specified for 1986, growth in excess of the established range would be acceptable.

**Indicative of likely range if more stable velocity behavior shows signs of re-emerging.

M2

Billions of Dollars

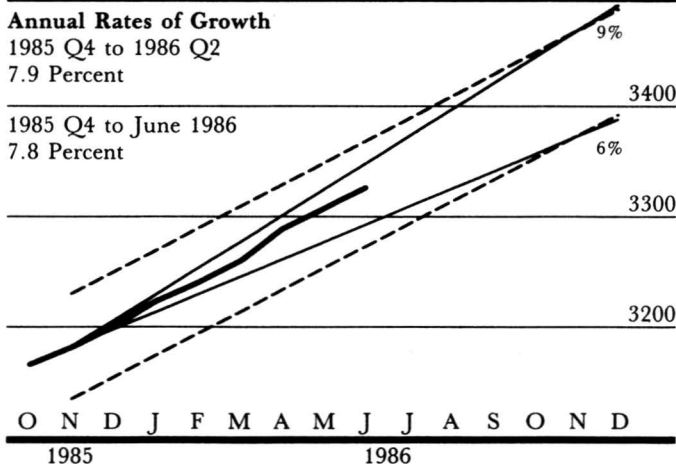


lowered by 1/2 percentage point, to 5½ to 8½ percent, to achieve money growth at a rate consistent with maintaining reasonable price stability and sustainable economic expansion.

The rapid rise in M1 over the first half of the year underscored the degree of uncertainty surrounding the behavior of the aggregate and, in particular, about its behavior relative to GNP. The

M3

Billions of Dollars

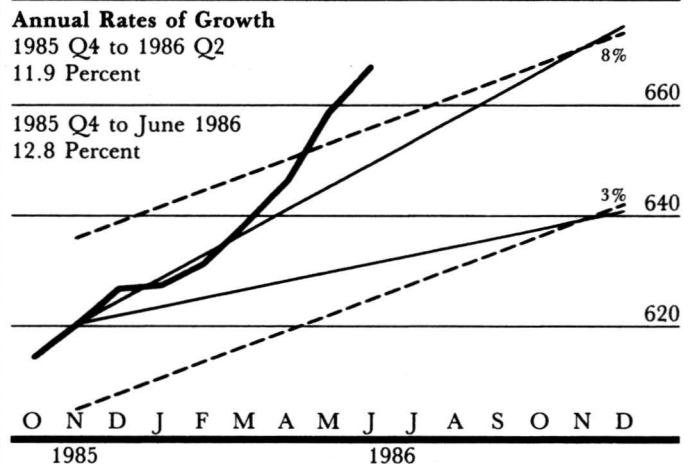


nature of the relationship among M1, income, and interest rates appears to have been significantly altered by the changed composition of the aggregate in recent years, as well as by the prospects for greater price stability. The Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable and growth in that aggregate over the balance of the year would continue to be evaluated in light of the behavior of the other monetary aggregates.

With respect to 1987, the Committee expressed the preliminary view that the current range for M1—3 to 8 percent—should provide for adequate money growth to support continued economic expansion, assuming that greater stability re-emerges in the link between M1 and income in a more stable economic, price, and interest rate environment.

M1

Billions of Dollars



Economic Projections

As is summarized in the table below, the central-tendency forecast is for growth of 2½ to 3 percent in real GNP this year. Such an increase in output would be expected to generate appreciable further gains in employment, but the unemployment rate might not drop below 7 percent before year-end.

In 1987, which would be the fifth year of the current expansion, real GNP is projected to increase 3 to 3½ percent, and unemployment is expected to decline moderately. A significant portion of the increase in production next year is expected to come from the external sector, with the lower value of the dollar expected to restrain the growth of imports and stimulate exports. However, with energy prices leveling off, exchange-rate-related increases in import prices are expected to cause an acceleration in inflation to the 3 to 4 percent range next year.

Progress in reducing the federal deficit is seen as crucial in maintaining financial conditions conducive to balanced growth and to an improved pattern of international transactions.

A critical element in the expected improvement in economic performance is progress toward reducing the size of the merchandise trade deficit. With import prices rising as a result of the depreciation of the dollar, the growth in imports is expected to slow, and the increased price competitiveness of U.S. goods should bolster export growth. However, a substantial improvement in our trade performance will require satisfactory growth of demand in other countries. Moreover, it will require open access to foreign markets, which underscores the critical importance of avoiding protectionist measures both here and abroad.

Economic Projections for 1986 and 1987

		FOMC Members and other FRB Presidents	
1986		Range	Central Tendency
Percent change, fourth quarter to fourth quarter:	Nominal GNP	3¾ to 6½	4¾ to 5¾
	Real GNP	2¼ to 3½	2½ to 3
	Implicit deflator for GNP	1½ to 3¼	2¼ to 2¾
Average level in the fourth quarter, percent:	Civilian Unemployment Rate	6.9 to 7.2	7
1987		Range	Central Tendency
Percent change, fourth quarter to fourth quarter	Nominal GNP	5 to 8¼	6 to 7½
	Real GNP	2 to 4¼	3 to 3½
	Implicit deflator for GNP	1½ to 4¼	3 to 4
Average level in the fourth quarter, percent:	Civilian Unemployment Rate	6½ to 7	Around 6¾

Economic Performance: First Half 1986

The economy continued to expand in the first half of 1986. Real GNP grew about 2½ percent, at an annual rate, according to preliminary Commerce Department estimates. The overall increase in output during the first six months of the year generated slightly more than one million new jobs, and the civilian unemployment rate held near 7 percent. At the same time, the dramatic decline in world crude oil prices caused a substantial slowing in inflation.

The combination of the lingering effects of the high foreign exchange value of the dollar during 1984 and 1985, the slow growth abroad, and the initial impact of lower crude oil prices played a key role in inhibiting any acceleration in overall economic activity. Industrial output declined noticeably over the first half, with activity reflecting the continuing intense competition from foreign producers in the manufacturing sector and also the sharp cutbacks in energy-related investment. U.S. agriculture confronts growing world supplies of many farm products, and many farmers continue to be squeezed by a heavy debt-servicing burden and falling land values. The drop in oil prices also has caused substantial adjustment problems.

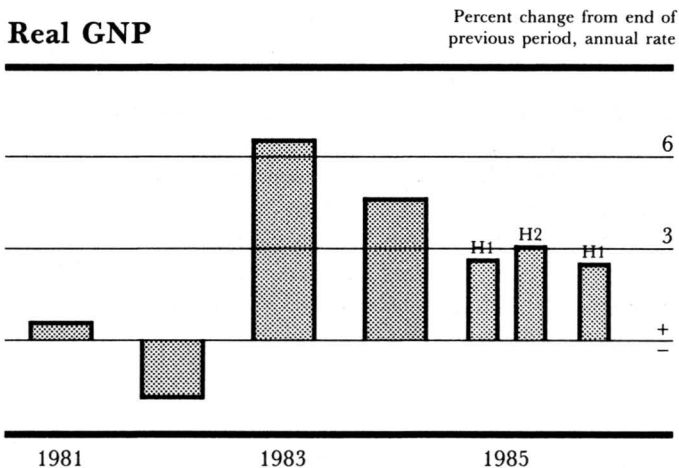
However, some of the benefits from the drop in oil prices did begin to emerge in the first half. The lower price of crude oil was reflected fairly quickly in the prices of finished energy products, which caused consumer prices to register their largest

three-month decline since the beginning of 1949. This lower price level has given a substantial boost to consumers' purchasing power and has helped to support higher levels of spending. Although the volume of oil imports will rise, the sharper decline in price is an aid in reducing the large deficit in our trade accounts.

A potentially more significant longer-term influence on our balance of trade is the lower value of the dollar. The prices of foreign goods are rising in dollar terms and should begin to shift expenditures from imports to domestic products. At the same time, U.S. goods are more competitive on world markets, although we have yet to experience a sustained improvement in exports.

The prospect of lower federal budget deficits in the years ahead, coupled with the drop in oil prices, encouraged sizable reductions in long-term interest rates at the beginning of 1986, which have begun to stimulate the interest-sensitive sectors of the economy. The most notable result has been in the housing sector where lower mortgage rates have led to substantial gains in building activity. Investment in new plant and equipment has not shown a similarly positive response to the lower interest rates. Apart from the negative effects of the oil drilling decline, business spending has been damped by the existence of a sizable overhang of office and factory space and by continuing uncertainties about sales trends and tax reform.

With the decline in energy prices, further progress has been made in reducing the inflation rate. Continued moderation in wage increases and abundant supplies of agricultural commodities and industrial raw materials also were important factors in restraining price increases in the first half of 1986. These favorable developments worked to offset the inflationary tendencies associated with the depreciation of the dollar and the continued rapid rise in the prices of services.



Price Developments

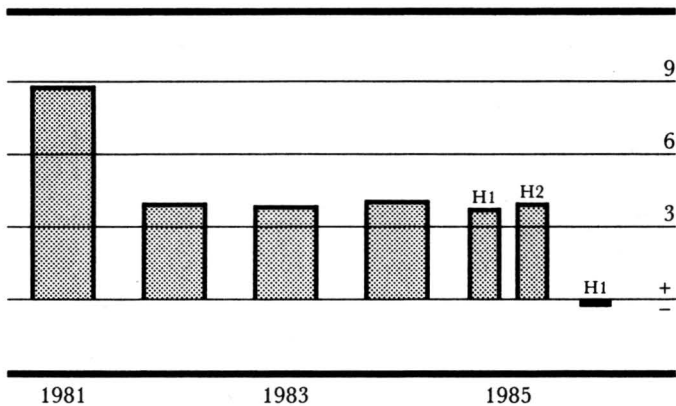
Falling energy prices were largely responsible for a significant slowing in measures of aggregate inflation during the first half of 1986. A broad measure of prices—the GNP fixed-weighted price index—increased at a 2¼ percent annual rate in the first half, down from a 3½ percent rise in 1985.

Consumer prices actually declined over the February to April period, but they still were up 1¾ percent over the twelve-months ended in June. The drop in prices was greater at the wholesale level, where weakness in the industrial sector added to the downward pressure from energy prices.

Outside of the energy area, further progress was made in reducing the inflation rate during the first half of the year. Retail food prices rose at only a 1 percent annual pace through June, held down by falling meat prices. A small decline in the prices of consumer goods was responsible for the slowdown in the CPI excluding food and energy to a 3½ percent annual rate of increase from its 4½ percent rise during 1985. In contrast, the prices of nonenergy services continued to increase at a 6 percent annual rate, boosted by rising housing costs and by higher premiums for most types of insurance.

Consumer Prices*

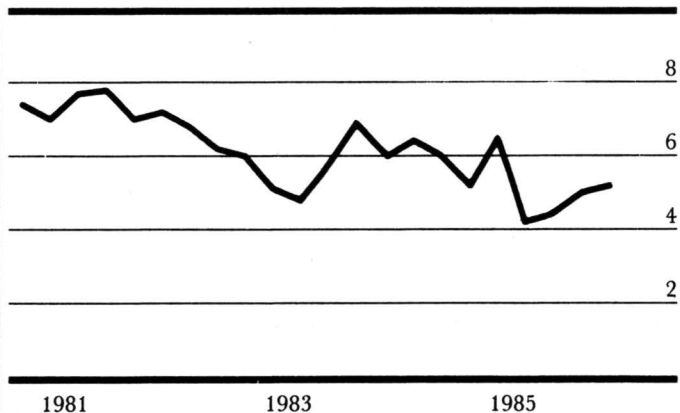
Percent change from end of previous period, annual rate



*Consumer Price Index for all urban consumers.

Personal Saving Rate

Percent of disposable income



The Household Sector

Consumer expenditures were quite strong in the first half of 1986, supported in part by rapid income growth. Real disposable personal income increased at about a 7 percent annual rate, boosted by high levels of farm subsidy payments and the energy-related slowdown in inflation.

The increase in consumer spending was widespread. Purchases of nondurable goods, such as apparel, were particularly strong in the first quarter, while outlays for services also grew briskly. The demand for new automobiles also remained quite high after the large sales increase in 1985.

Indicators of the financial position of the household sector were mixed in the first half of the year. Although the growth in consumer credit slowed from its rapid growth pace in 1985, the ratio of consumer installment debt to disposable income edged up to a new high. The rallies in the stock and bond markets strengthened the asset side of the household sector balance sheet. Many homeowners took the opportunity presented by the decline in interest rates to ease their debt-servicing burdens by refinancing mortgage loans. However, increased strains also were evident, as personal bankruptcies rose to record levels and mortgage delinquency rates remained historically high.

The Business Sector

The financial position of the business sector improved during the first half of 1986, albeit with considerable diversity across industries. Economic profits in the corporate sector rose at an \$11 billion annual rate in the first quarter. Financial conditions in agriculture and manufacturing remained weak, however. Agriculture continued to be hurt by excess supply conditions worldwide, and farm loan delinquencies rose to a postwar high. In manufacturing, intense price competition from foreign sources squeezed profit margins, and with little growth in demand, capacity utilization moved lower.

Business spending on plant and equipment was weak in the first half of the year. This poor performance partly reflected a "payback" after very strong capital spending in the fourth quarter of 1985. Firms apparently accelerated their spending at the end of last year to take advantage of investment incentives that were targeted for scaling back or elimination under proposed tax reform legislation; expenditures then dropped off in the first quarter of 1986.

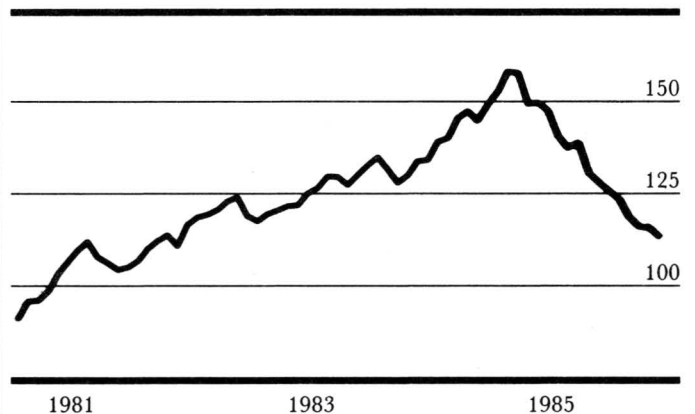
Much of the change in business inventories in the first half of this year was associated with fluctuations in automobile dealers' stocks. Domestic car production outpaced sales in the first quarter, and this resulted in a substantial build-up of auto inventories. Manufacturers continued to trim their stocks, preferring to keep inventories lean until there was firm evidence of a resurgence in demand.

The Foreign Sector

The dollar depreciated further against the currencies of foreign industrial countries during the first half of 1986. On balance, the trade-weighted value of the dollar has fallen over 30 percent from its February 1985 peak, about one-third of which has occurred this year. Associated with the depreciation was a narrowing in inflation-adjusted interest rate differentials between the United States and the other major industrialized countries, as interest rates declined both here and abroad.

Exchange Value of the U.S. Dollar*

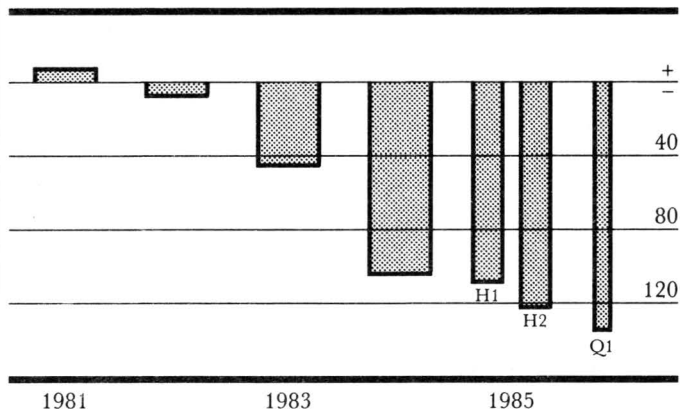
Index, March 1971 = 100



*Federal Reserve index of weighted average exchange value of U.S. dollar against currencies of other G-10 countries plus Switzerland. Weights are 1972-76 global trade of each of the 10 countries.

U.S. Current Account

Annual rate,
billions of dollars

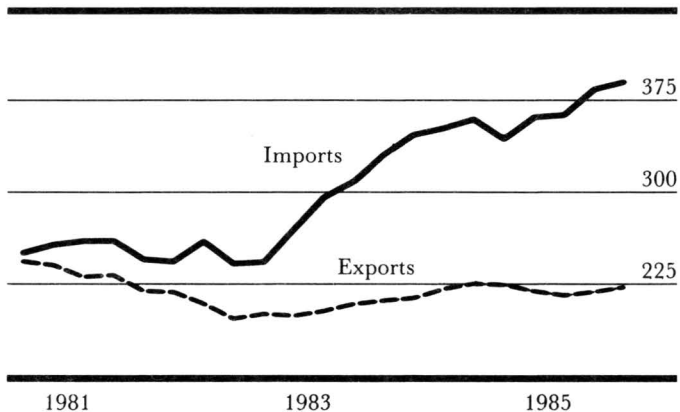


Although a substantial correction has occurred in the dollar's value, at least against the currencies of the major industrialized countries, the nation's current account deficit was unchanged in the first quarter from the high \$135 billion rate of the fourth quarter of 1985. This lack of improvement was the result of large increases in nonpetroleum imports while exports grew more slowly.

Yet, the decline in the dollar improved the price competitiveness of U.S. goods in foreign markets.

U.S. Real Merchandise Trade

Billions of 1982 dollars



However, exports have been slow to pick up, in important part, because of the sluggish pace of foreign economic activity.

The volume of U.S. merchandise imports rose 1½ percent in the first quarter of 1986. The largest increases were in machinery, with smaller advances registered for some consumer goods. The volume of merchandise exports was up somewhat in the first quarter, with a 3½ percent decline in exports of agricultural products offset by increased U.S. nonagricultural exports.

Money, Credit, and Monetary Policy

The Committee emphasized that policy implementation would involve a continuing appraisal of trends in all of the money and credit measures, as well as of indicators of economic activity and prices, and conditions in credit and foreign exchange markets. Within this framework for policy, the Federal Reserve basically accommodated the demands for reserves associated with strong M1 growth over the first half of 1986.

In the initial months of 1986, growth of M1 dropped off sharply from its rapid 1985 pace, and growth of M2 also slowed substantially, to a rate below its annual target range. There were signs of some sluggishness in economic activity, and steep declines in oil prices, which were improving the outlook for inflation, contributed importantly to a rally in long-term credit markets that picked up momentum in mid-February. At the same time, short-term interest rates edged a little lower, but the federal funds rate remained significantly above the Federal Reserve's discount rate.

In this context, a cut in the discount rate would complement the thrust of open-market operations and would accommodate the market tendency toward lower interest rates. However, an important consideration in the timing and extent of any rate cut was the risk posed by an excessive reaction in the foreign exchange markets, where the dollar remained under downward pressure during much of the period.

On March 7, the Federal Reserve cut the interest rate charged for discount window borrowings by 1/2 percentage point to 7 percent. The central banks of Japan, Germany and several other industrial nations took similar actions around the same time.

On April 18, the Federal Reserve announced another reduction in the discount rate, to 6½ percent. This change served primarily to catch up with

and validate declines that already had taken place in market rates. Exchange rates and international interest rate considerations again played a role, and our discount rate cut coincided with a rate cut by the Bank of Japan.

With market interest rates falling, price pressures remaining subdued, and the economies of the United States and other industrial countries growing relatively slowly, the Federal Reserve again reduced

Growth of Money and Credit (Percentage changes at annual rates)

Period		M1	M2	M3	Domestic Nonfinancial Debt
Fourth quarter 1985 to second quarter 1986		11.9	7.3	7.9	13.0 ^c
Fourth quarter 1985 to June 1986		12.8	7.8	7.8	12.7 ^c
Fourth quarter to fourth quarter	1979	7.5	8.1	10.3	12.3
	1980	7.3	9.0	9.6	9.6
	1981	5.2 (2.5) ¹	9.3	12.3	9.8
	1982	8.7	9.1	10.0	9.0
	1983	10.4	12.2	9.9	11.2
	1984	5.4	8.0	10.5	14.3
	1985	11.9	8.6	7.6	14.0
Quarterly average 1985	Q1	10.1	11.7	10.2	13.6
	Q2	10.5	6.3	5.5	12.0
	Q3	14.5	9.5	7.6	12.9
	Q4	10.7	6.0	6.5	14.6
Quarterly average 1986	Q1	7.7	4.3	7.4	16.1
	Q2	15.8	10.3	8.3	9.6 ^c

e—estimated

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

the discount rate by 1/2 percentage point, to 6 percent on July 11.

On balance, since the end of 1985 the dollar has declined more than 10 percent, and short-term rates about 1½ percentage points. Long-term Treasury yields fell 2 percentage points, but yields on other long-term securities fell less; corporate and tax-exempt bond yields dropped about one point, and fixed-rate mortgages fell just 1/2 percentage point.

In contrast to M1, which grew at a 12¾ percent annual rate through June, both M2 and M3 grew moderately in the first half of the year and in June were near the middle of their respective ranges. Some of the more liquid components of the broader monetary aggregates, however, increased very rapidly, as part of the larger shift in investor portfolios toward short-term assets. This shift had much less effect on M2 or M3 than on M1, because the reallocation of funds took place largely within these broader aggregates. In addition to transaction deposits, money market deposit accounts, money market mutual funds, and ordinary savings deposits all expanded strongly during the first half of the year, but small time deposits grew only slightly.

The debt of domestic nonfinancial sectors is estimated to have expanded at a more moderate rate over the first six months of 1986 than it had in some time. Bond issuance had surged in December in advance of the possible effective date of some provisions of tax-reform legislation, lifting the first-quarter level of the debt aggregate. Hence, when measured from its fourth-quarter-average base, the growth of domestic nonfinancial sector debt has remained above its monitoring range, coming in at a 12¾ percent annual rate through June. Measured from its level at the end of December, however, debt grew at an annual rate of 10¼ percent through the end of June.

The stresses evident in many parts of the economy left their mark on the books of banks and of other financial institutions. Asset quality deteriorated as a consequence of the sharp drop in oil prices and associated dislocations in the energy sector, overbuilding in commercial real estate, and the continuing distress in agriculture. Banks with relatively large amounts of farm loans outstanding, as well as other agricultural lenders, have been particularly

hard hit recently; loan losses at these institutions have soared and their profitability has continued to slide. While banks in regions with economies heavily dependent on energy production were among the most strongly capitalized and profitable earlier, their financial position has eroded under the pressure of surrounding economic difficulties. Bank failures in the first half of this year continued to run at about 1985's rapid pace, with agricultural banks again accounting for a disproportionate share.

At savings and loan associations, overall profitability appears to be improving as interest rates have declined and mortgage origination activity has surged. However, a substantial number of these institutions continue to have severe problems owing primarily to losses on weak assets, prompting proposals to add to the financial resources of the FSLIC.

Concern over loans to certain developing countries came to the forefront again this year as Mexico began to grapple with the additional economic and financial problems brought on in large part by dramatically lower oil prices. Banks have remained cautious lenders in the face of ongoing concerns about the economic and financial prospects of these countries.

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.

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

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