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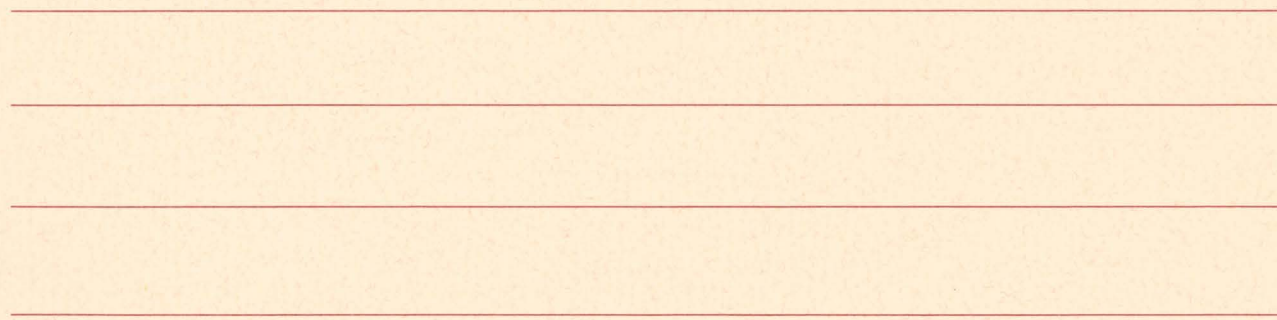
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Monetary Policy Objectives for 1987

Summary Report of the
Federal Reserve Board
February 19, 1987



Federal Reserve System Board of Governors



Monetary Policy Objectives for 1987

Summary of Report to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978. February 19, 1987.

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Monetary Policy and the Economic Outlook for 1987

The current economic expansion in the United States has entered its fifth year, ranking it among the longest of the postwar period. While substantial imbalances and risks have emerged in the course of the expansion that must be dealt with forcefully and effectively, important groundwork also has been laid for continued growth through 1987 and beyond. Significantly, price trends thus far have remained favorable, reflecting not only the dramatic drop in crude oil prices in early 1986 but also continued restraint on labor costs in many sectors.

Interest rates have moved lower and stock prices higher, reducing the cost of capital for investment and enhancing wealth. Furthermore, processes are in train that should help correct the major imbalances that have been plaguing the economy: action has been taken to cut the deficit in the federal budget, and the foreign exchange value of the dollar has moved to levels that have made U.S. firms more competitive in world markets and should help correct the imbalance in the U.S. external accounts.

While the potential for further economic progress thus appears considerable, those gains will be secured only if there is timely and constructive action by decisionmakers in the public and private sectors. Congress and the Administration must follow up the steps already taken and make basic programmatic changes that will ensure continuing movement toward budgetary balance; failure to do so would be damaging to confidence and disruptive to the financial markets. Many of our major trading partners, which have depended greatly on external surpluses to buoy their economies over the past few years, must act to open their markets more fully and to foster sustained growth in domestic demand; without such action, prospects for world growth as well as for reducing our own trade deficit would be impaired, the risks of protectionism would rise, and prospects for the dollar would be more uncertain. And, if we are to capitalize on those trading opportunities and promote economic and financial stability at home, labor and management must avoid a return to the inflationary behavior of the past. Oil prices have firmed recently, and the sizable decline in the dollar is likely to exert upward pressure on other prices in the months ahead; the challenge is to prevent such developments from triggering a cumulative price-wage spiral.

Ranges of Growth for Monetary and Credit Aggregates¹

Percent change, fourth quarter to fourth quarter

	1987	1986	
		Target	Actual
M2	5½ to 8½	6 to 9	8.9
M3	5½ to 8½	6 to 9	8.8
Debt	8 to 11	8 to 11	12.9

Federal Reserve policy has a critical role to play. Monetary expansion, while adequate to support orderly economic growth, needs to be consistent with continuing progress over time in reducing the underlying rate of inflation. As the experience of recent years has demonstrated, such a policy—in part by bolstering confidence in financial markets and providing a framework of greater certainty for private decisionmaking—can make a substantial contribution to the maintenance of expansion and the reduction of unemployment. In the short run, a variety of factors—such as interest rate movements, regulatory changes, and institutional innovations, among others—may alter considerably the amount of funds the public wishes to hold in monetary form. Over time, however, expansion of the money stock measures clearly must moderate from recent rates if destabilizing pressures are to be avoided. The Federal Open Market Committee (FOMC) has established targets for 1987 with that fact in mind, but it will continue to interpret the movements in the monetary aggregates in light of developments in the economy and in domestic and international financial markets and the potential for inflationary pressures.

Monetary Policy for 1987

The FOMC believes that a reduction in the growth of the money supply measures, over time, will be needed if the economy is to achieve noninflationary growth and external equilibrium. The precise timing and degree of that moderation in monetary expansion will depend on prevailing circumstances in the U.S. economy and in domestic and international financial markets. The Committee has established target ranges for M2 and M3 of 5½ to 8½ percent from the fourth quarter of 1986 to the fourth quarter of 1987. The ranges for M2 and M3 are one-half percentage point below those in effect for 1986, and are below the actual growth rates last year. Indeed, in an environment without the dramatic movements in interest rates of recent years, only small changes in the velocity of these aggregates would be anticipated. The Committee now expects growth of M2 and M3 this year to be in the middle of their ranges.

The FOMC elected not to establish a specific target range for M1 at this time because of uncertainties about its underlying relationship to the behavior of the economy and its sensitivity to a variety of economic and financial circumstances. With the deregulation of deposit rates, and the attendant changes in the composition of M1, the narrow money measure has become much more responsive in the short run to changes in interest rates, and possibly to other factors affecting the portfolio decisions of households.

Moreover, only with the passage of time will it become possible to assess with any precision the longer-term trend in growth of M1, under current institutional arrangements, relative to nominal GNP. Given these circumstances, the appropriateness of different rates of M1 growth cannot be assessed in isolation; rather, the movement of this aggregate necessarily will be evaluated in the light of expansion in M2 and M3, growth of the domestic economy, and emerging price pressures, which in turn are partly related to changes in the value of the dollar.

The Committee will continue to monitor the growth of debt. Growth of domestic nonfinancial sector debt in recent years consistently has exceeded both the Committee's expectations and, more important, the expansion of income by a wide margin. This is a matter of concern, for it has resulted in potential fragilities in the nation's financial structure. Although the range for the debt measure has been kept at 8 to 11 percent, the same as in 1986, that range implies a significant slowing from the almost 13 percent pace last year—but to a rate still in excess of that expected for income. With a reduced federal deficit, borrowing by the federal government will slow. Also, new constraints imposed by tax reform legislation should reduce the presence of state and local governments in the financial markets. Borrowing by nonfinancial business firms is expected to grow at about the same rate as last year. Tax reform should result in some reduction in the volume of

Economic Projections for 1987 (percent)

		FOMC members and other FRB Presidents		Administration
		Range	Central Tendency	
Change, fourth quarter to fourth quarter:	Nominal GNP	4½ to 7½	5¾ to 6½	6.9
	Real GNP	2 to 4	2½ to 3	3.2
	Implicit deflator for GNP	2½ to 4	3 to 3½	3.6
Average level in the fourth quarter:	Unemployment Rate	6½ to 6¾*	6½ to 6¾*	6.5

*Civilian unemployment rate.

equity shares retired in connection with mergers and other corporate restructurings, but such activity—and the attendant borrowing—appears likely to remain significant, in some cases undermining the financial strength of corporations as they become more heavily leveraged. Moreover, firms may have a wider gap than last year between internally generated funds and investment expenditures, owing in part to higher corporate tax bills. Growth of household debt also is expected to be about the same as last year. Consumer installment credit clearly is decelerating, but growth of mortgage debt should be robust, reflecting both a good housing market and the substitution of home equity lines of credit for installment borrowing.

Economic Projections

The Committee believes that its monetary objectives are consistent with continued moderate growth in economic activity and a relatively modest upturn in inflation in 1987 that would be attributable almost entirely to higher import prices and a rebound in energy costs. The central tendency of the forecasts of Committee members and other Reserve Bank Presidents is for growth in real GNP of around 2½ to 3 percent. Such an increase in output would be expected to generate substantial gains in employment, and the jobless rate is projected to drift down a bit over the year. Prices, as measured by the implicit deflator for GNP, are expected to rise 3 to 3½ percent. It should be noted that the rise in energy and import prices likely will have a somewhat greater effect on consumer prices, so that measures such as the Consumer Price Index may rise faster than the GNP deflator—a pattern that emerged in the second half of 1986.

The forecasts of the Committee members and the other Reserve Bank Presidents assume that Congress will make further progress in reducing the federal budget deficit. Continuing evidence of fiscal restraint is viewed as crucial in maintaining financial conditions that are conducive to balanced growth and an improved pattern of international transactions.

Orderly growth in GNP has become increasingly dependent upon a substantial improvement in real net exports. The international competitiveness of U.S. firms clearly has benefited from the decline in

the dollar, and this should bolster export growth and help curb the expansion in imports. But there still is considerable uncertainty about some of the other factors affecting the external sector. In particular, the expansion in exports is contingent on a satisfactory pace of economic activity abroad over time, on continued progress in handling international debt problems, and on enhanced access to foreign markets. On the import side, the improvement is predicated on a substantial rise in the relative price of foreign goods. That unfortunately carries with it some domestic inflationary risks, underscoring the need for prudent fiscal and monetary policies.

Slower growth of domestic demand is expected to release resources to the external sector in 1987. Consumer spending is projected to rise less rapidly than in 1986, given that the saving rate has fallen to an extremely low level and real income gains in 1987 are likely to be damped by rising energy and non-petroleum import prices.

The effect of the dollar depreciation on prices is likely to be felt more strongly in 1987. In addition, crude oil prices have rebounded in the past few months, reversing part of the sharp drop that occurred early last year. However, the favorable trend in wages and other costs, combined with sizable productivity gains in manufacturing, provides the opportunity for absorbing these short-run price shocks while maintaining a sense of progress toward greater underlying price stability. The Committee's projections anticipate that neither significant capacity constraints nor strong labor market pressures will develop and that domestic firms will not squander the opportunity to regain markets in a shortsighted effort to expand profit margins unduly as demand for their products increases.

The central tendency projections of real GNP and inflation are slightly lower than the forecasts of the Administration. However, given the uncertainty of economic forecasting, the differences are not significant, and, in fact, the Administration projections are well within the full range of expectations among Committee members and other Reserve Bank Presidents.

Economic Performance During the Past Year

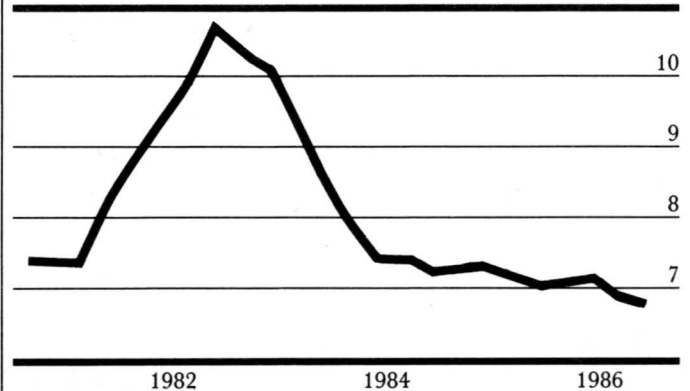
In 1986 the economy completed a fourth consecutive year of expansion, with real gross national product increasing a little more than 2 percent. The rise in overall activity was similar to the gains that had been recorded, on balance, since mid-1984 and was sufficient to create 2½ million new payroll jobs. The jobless rate for civilians continued to edge down and, at year-end, was 6¾ percent.

Inflation slowed sharply with virtually all broad measures of price trends showing their smallest increases in many years. Although the sharpness of the deceleration owed much to specific developments in the markets for oil and other commodities, the favorable inflation performance also represented at a fundamental level the continuation of trends in wage and price behavior fostered by policies in place since the early part of the decade.

Although output continued to grow in 1986, the economy still was characterized by pronounced imbalances. These were reflected in marked disparities in economic performance across industries and regions of the country. In particular, domestic oil exploration and investment was cut back sharply, and only massive federal subsidies sustained many

Civilian Unemployment Rate

Quarterly average, percent

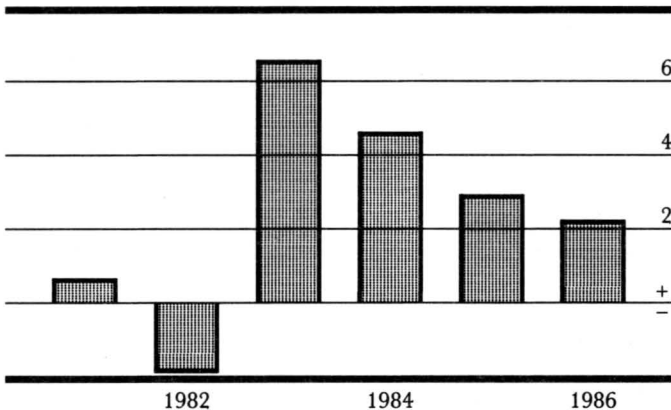


farm enterprises faced with sharply lower crop prices. In addition, major segments of the industrial sector continued to struggle with intense foreign competition, and relatively low rates of capacity utilization—along with a glut of office space—depressed capital spending.

The most serious imbalances continue to be in the external sector and in the federal budget—developments that are linked. Although the foreign exchange value of the dollar against the other G-10 currencies has declined roughly 40 percent over the past two years, the nation's trade balance continued to deteriorate in 1986. Real export growth did pick up in response to the enhanced international competitiveness of U.S. firms, although the rebound was damped somewhat by the relatively slow growth of the economies of our major trading partners. However, import volumes continued to expand rapidly through most of the year, in part because much of the swing in

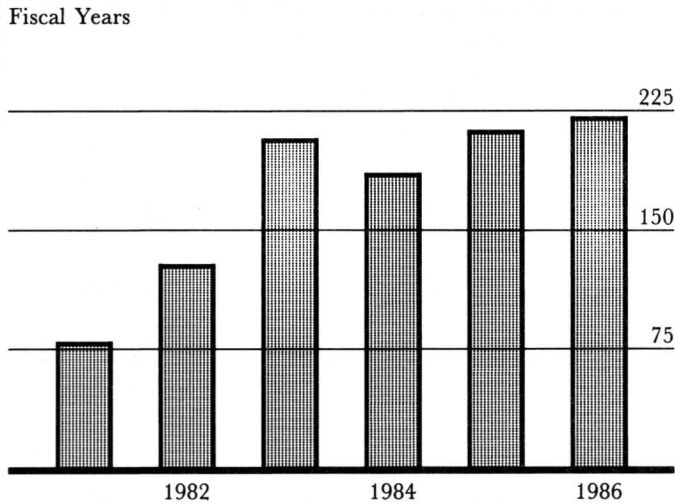
Real GNP

Percent change, Q4 to Q4



Federal Government Deficit

Billions of dollars



exchange rates apparently was absorbed in the profit margins of foreign exporters and U.S. distributors, thereby limiting increases in the prices of imported goods. As a result, the current account deficit continued to widen, reaching the \$150 billion range in 1986.

The federal budget deficit also increased, hitting \$221 billion in fiscal 1986. The deficit vastly exceeded official targets, as underestimates of program costs and shortfalls in revenues offset the deficit-reducing actions taken by the Administration and the Congress. Recent estimates suggest that the deficit for fiscal year 1987 will decline to the \$175 billion range, which is a good deal less than the year earlier but considerably above the Gramm-Rudman-Hollings target of \$144 billion.

Price & Wage Developments

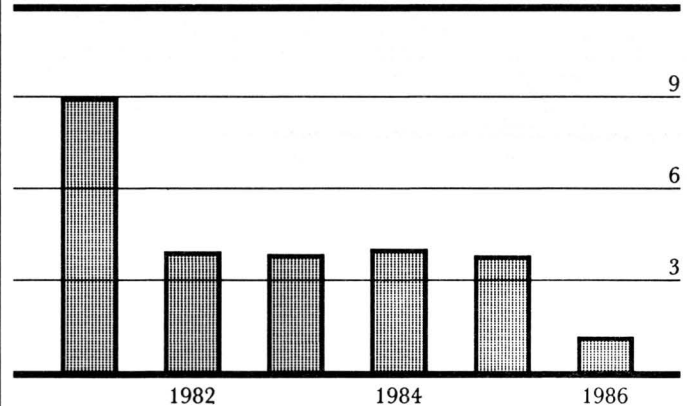
The fixed-weighted price index for GNP rose about 2½ percent in 1986, down from an increase of 3½ percent in 1985. The increase was the smallest in more than two decades. Some other popular measures of prices decelerated even more markedly. The Consumer Price Index (CPI) for goods and services rose only about 1 percent, and the Producer Price Index (PPI) for finished goods actually fell 2½ percent.

The greater deceleration in the CPI and PPI than in the GNP price measure is a reflection of the greater importance of energy prices in those indexes. The movements in energy prices over the past year or so have been striking. World crude oil prices dropped from \$26 per barrel in late 1985 to the \$11 per barrel range around mid-year; these prices trended up over the second half and recently have risen to around \$18 per barrel in the wake of the agreement on production limits reached at the OPEC meeting in late December. The drop in crude oil prices was reflected fairly rapidly in retail energy prices which declined 20 percent last year. The effects of the recent firming in oil prices are already evident in general indexes: the PPI jumped 0.6 percent in January, owing largely to the rebound in gasoline and heating oil prices.

Price increases outside the energy area generally remained moderate in the past year. Retail food prices rose 4 percent, a bit more than in 1985,

Consumer Prices*

Percent change,
December to December



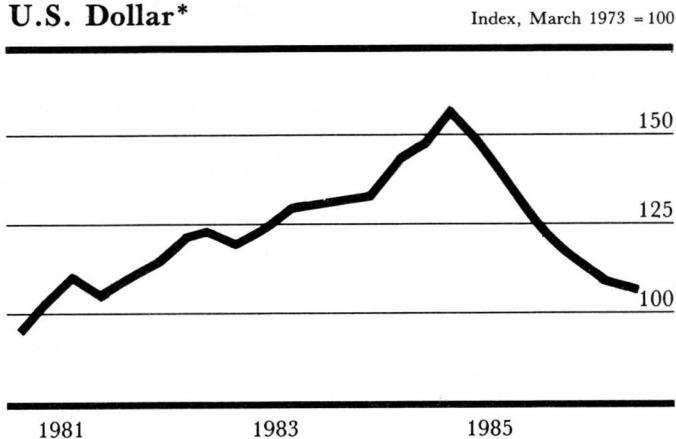
*Consumer Price Index for all urban consumers.

reflecting the effects of last summer's heat wave in the Southeast. However, prices of retail goods, excluding food and energy, continued to slow and, on balance, were up only 1½ percent. The influence of the depreciating dollar on consumer goods prices was highly variable across sectors and relatively small overall.

Prices for many basic industrial commodities continued to decline over the first three quarters of 1986. Excess capacity in some basic industries and the generally abundant world supplies of many primary commodities contributed importantly to the weakness in these prices. Sluggish industrial activity in the United States and other large economies also was a factor. Prices in a number of these markets have turned up in recent months, possibly in response to the firming in U.S. industrial activity. Nonetheless, industrial commodity prices still are well below the most recent peaks reached in mid-1984.

Wages continued on a path of moderation in 1986. Hourly compensation in the nonfarm private sector, as measured by the employment cost index, rose about 3¼ percent, ¾ percentage point less than in 1985. The deceleration in wages reflected the continued slack in labor markets as well as the reduction in price inflation, and was widespread across industries and occupations.

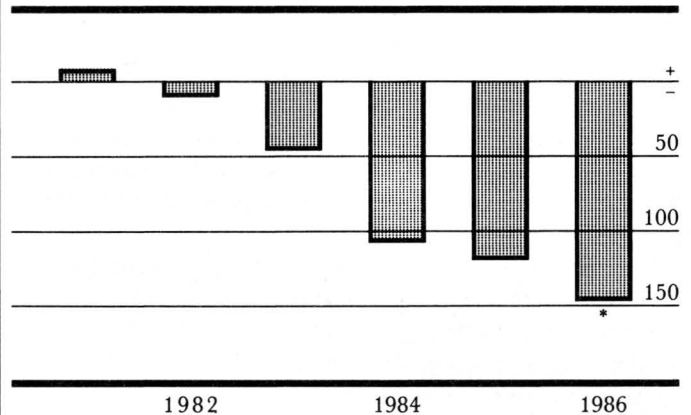
Exchange Value of the U.S. Dollar*



*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

Billions of dollars



*Estimated.

The External Sector

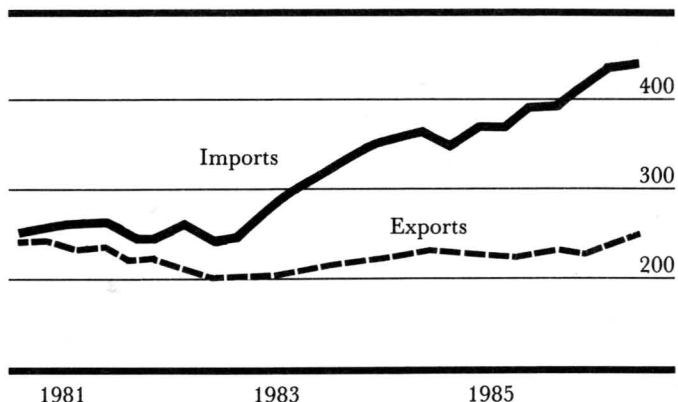
Widening U.S. trade and current account deficits have aroused deep concern because of their implications both for the orderly expansion of the domestic economy and for international financial stability. The foreign exchange value of the dollar, which had declined about 20 percent against a weighted-average of the currencies of other G-10 countries from February 1985 to December 1985, has fallen an additional 20 percent since that time. Because the U.S. inflation rate over the past two years was approximately the same as the average inflation rate in other G-10 countries, the decline in the real value of the dollar (that is, adjusted for relative inflation rates) was similar to the nominal decline.

As measured by broader exchange-rate indexes, which include the currencies of major developing countries as well, the real decline in the value of the dollar was somewhat smaller. This was due in part because some of those countries allowed their currencies to depreciate as part of an effort to improve their external positions. On such broader measures, the appreciation of the dollar in real terms through early 1985 also was smaller.

The decline in the dollar over the past year was associated with a fall in interest rates on dollar-denominated assets relative to rates on assets denominated in other currencies. Moreover, some correction of the dollar's external value was seen to be an essential element in the process of reducing over time the huge U.S. current account deficit and restoring better balance in the United States and world economies. The apparently muted response of the current account to the dollar's depreciation through most of 1986 contributed to sharp downward pressure on the dollar in early 1987.

The volume of merchandise imports rose sharply in 1986, with increases widespread across products and countries of origin. Petroleum imports surged as prices plunged. Domestic production contracted, and nonpetroleum imports continued to grow at about the rapid 1985 pace. In part, the sustained strength of nonpetroleum imports reflected the relatively moderate increase to date in prices of these goods; foreign exporters to the United States and U.S. distributors, whose profit margins had widened substantially during the period of dollar appreciation in the early 1980s, were able to absorb initially a large

U.S. Real Merchandise Trade Billions of 1982 dollars



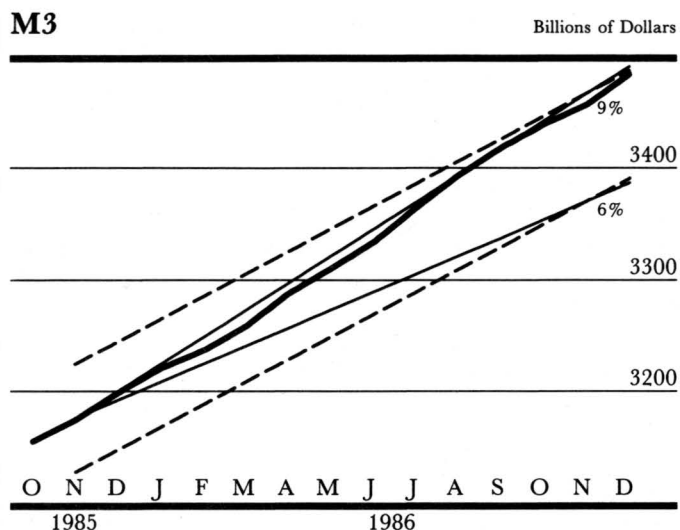
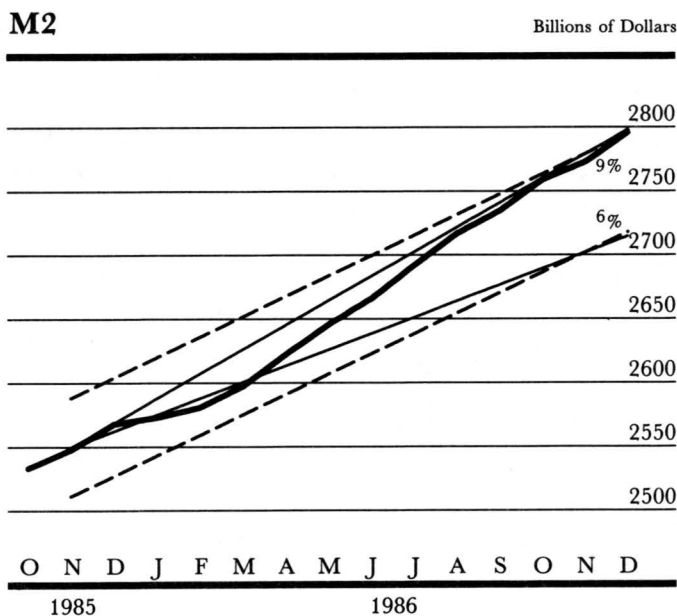
proportion of the dollar's depreciation. In addition, since early 1985, the dollar has appreciated in real terms relative to the currencies of Canada and some developing countries, which account for almost half of U.S. nonpetroleum imports.

Meanwhile, the volume of merchandise exports picked up last year. This improvement mainly reflected the enhanced international competitiveness of U.S. goods in foreign markets that stemmed from the decline in the dollar, as the pace of foreign economic activity generally remained sluggish. Growth last year for the major industrialized countries as a group was slower than in 1985, in part because of a pronounced deceleration in Japan. Activity in many developing countries was damped by subdued growth in the industrialized world and the continuing pressures of external debt-servicing obligations. Weakness in world commodity prices also has aggravated the financial difficulties of many developing nations, including oil-exporting countries.

Monetary Policy and Financial Markets in 1986

At its meeting in February 1986, the FOMC established target growth ranges, measured from the fourth quarter of 1985 to the fourth quarter of 1986, of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3. The associated monitoring range for growth of domestic nonfinancial debt was set at 8 to 11 percent. Based on the experience of recent years, the Committee recognized that the relationship between M1 and economic activity was subject to particularly great uncertainty. Accordingly, the FOMC agreed to evaluate movements in M1 in light of their consistency with the patterns in other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures.

M1 was well above its annual target range at the time of the July FOMC meeting. The available evidence suggested that the rapid growth of M1 reflected shifts in portfolios toward liquid assets in the context of declining market interest rates rather than excessive money growth with potential inflationary consequences. Against this background, the Committee

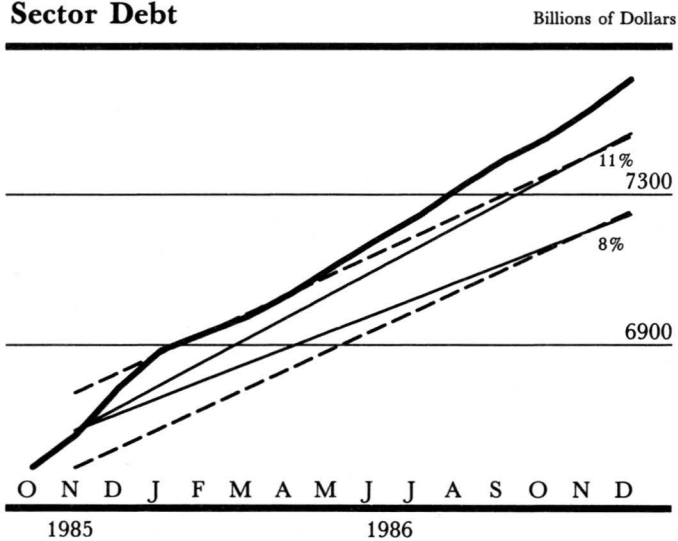


concluded that M1 growth above the existing range would be acceptable, provided the broader aggregates expanded within their target ranges, price pressures remained subdued, and the economy continued to expand at a moderate pace. The Committee reaffirmed the target ranges for M2 and M3 at its July meeting. Committee members felt that growth within those ranges for the year was still consistent with the overall policy objectives of reducing inflation further, promoting sustainable growth in output, and contributing to an improved pattern of international transactions. In the first half of the year, the growth of domestic nonfinancial debt exceeded both its monitoring range and the growth of nominal GNP, as it had in previous years. The Committee was concerned about the burdens and potential instabilities associated with the persistence of rapid debt growth and felt that raising the monitoring range for debt would create an inappropriate benchmark for evaluating long-term trends. As such, the existing range was maintained, but the FOMC thought that debt growth could well exceed its upper bound.

The growth of M2 quickened in the second half of the year, and M3 expanded at a somewhat faster pace as well. However, both of the broader aggregates ended the year within—although near the upper bounds of—their target ranges. The growth of M1 accelerated further in the second half of the year, resulting in a record postwar decline in velocity for 1986. The growth of nonfinancial debt slowed slightly in the second half of the year, but still exceeded its monitoring range by nearly 2 percentage points.

Pressure on reserve positions of depository institutions, as reflected in a relatively low volume of borrowing at Federal Reserve Banks, changed little over

Total Domestic Nonfinancial Sector Debt



the course of 1986. The broadly accommodative thrust of policy was manifest in the four reductions in the discount rate between March and August. In part, the discount rate cuts were intended to keep this rate in line with the yields on short-term market instruments. They also were taken in the context of hesitant worldwide economic growth, an improved inflation outlook, and growth of the broader monetary aggregates within their annual target ranges.

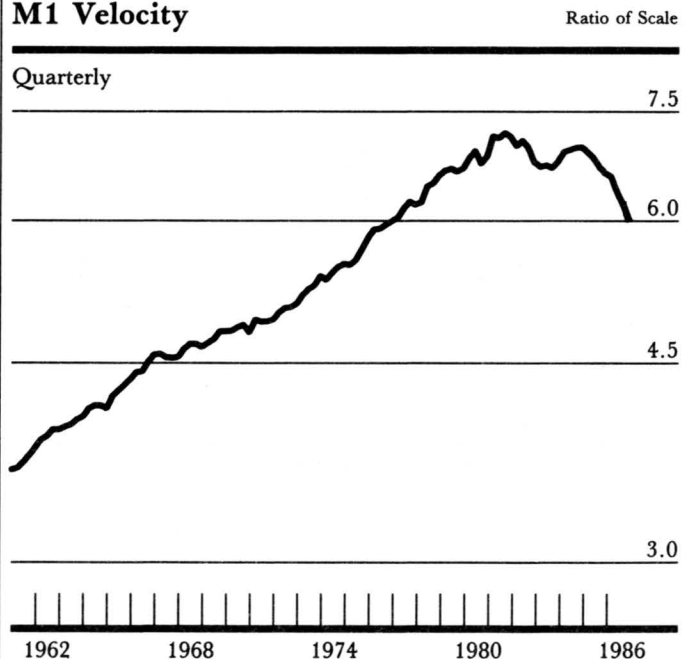
In setting monetary policy the FOMC focused considerable attention on the nation's trade deficit and the foreign exchange value of the dollar. The Committee members generally viewed the narrowing in the trade deficit as a key to achieving a sustain-

able and more even expansion of activity across the economy. At the same time, however, the Committee was concerned that an unduly precipitous decline in the dollar against the currencies of our major trading partners could contribute to inflationary pressures in the United States. To help limit the effect on the value of the dollar, the first reduction in the discount rate was a coordinated action with other major central banks; similarly, the reduction in April was accompanied by a cut in the Japanese discount rate.

Money, Credit, and Monetary Policy

M2 expanded almost 9 percent in 1986, placing this aggregate near the upper bound of its annual growth target. Although in recent years this aggregate has exhibited a tighter relationship with nominal GNP than M1 has, its velocity still registered a decline of 4 percent last year and reached its lowest level in decades. The buildup of M2 balances relative to income probably reflected incentives to place savings in various components of the aggregate whose offering rates were falling more slowly than market interest rates.

M1 Velocity



The changing structure of deposit rates at banks and thrifts has led to a pronounced shift in the composition of M2. Inflows to transactions deposits, savings deposits, money market deposit accounts, and money market mutual fund shares were very strong last year, while small time deposits ran off, marking the second consecutive year of zero or negative growth.

M3 also ended the year near the upper bound of its annual range, increasing $8\frac{3}{4}$ percent in 1986. Growth of M3 close to that of M2 is not surprising, given that M2 constitutes four-fifths of the larger aggregate. The remaining share is dominated by large time deposits and certain other managed liabilities of depository institutions. Credit growth at banks and thrifts remained quite strong last year, but with the exception of the first quarter, the use of managed liabilities in M3 was light as growth of core deposits largely was sufficient to fund asset

expansion. Large CDs expanded only 3 percent on balance in 1986, with commercial banks paying down their outstanding CDs during much of the year and thrift institutions doing the same in the fourth quarter. The weakness in CDs was widespread as institutions relied more on other managed liabilities, such as term RPs, included in M3, and advances from Federal Home Loan Banks, not included in M3.

The broad shift to liquid assets greatly affected the behavior of M1. The narrow monetary aggregate expanded more than 15 percent in 1986, marking the second consecutive year of double-digit growth. The velocity of M1 fell $9\frac{1}{2}$ percent last year, compared with a decline of $5\frac{1}{4}$ percent in 1985. Since 1981 the velocity of M1 has declined 16 percent—a remarkable development in view of its tendency to climb about 3 percent per year in the previous two decades. Much of the rapid growth in narrow money over the past two years appeared to be related to the

Growth of Money and Credit (Percentage changes)²

Period		M1	M2	M3	Domestic Nonfinancial Debt
Fourth quarter to fourth quarter	1979	7.9	8.2	10.4	12.2
	1980	7.3	8.9	9.6	9.6
	1981	5.1 (2.4) ³	9.2	12.3	9.9
	1982	8.6	9.1	9.9	8.9
	1983	10.2	12.1	9.8	11.5
	1984	5.4	7.9	10.7	13.9
	1985	12.1 (12.7) ⁴	8.8	7.7	13.5
	1986	15.2	8.9	8.8	12.9
Quarterly growth rates 1986	Q1	8.8	5.3	7.7	15.4
	Q2	15.5	9.4	8.7	10.3
	Q3	16.5	10.6	9.7	12.0
	Q4	17.0	9.0	7.8	11.5

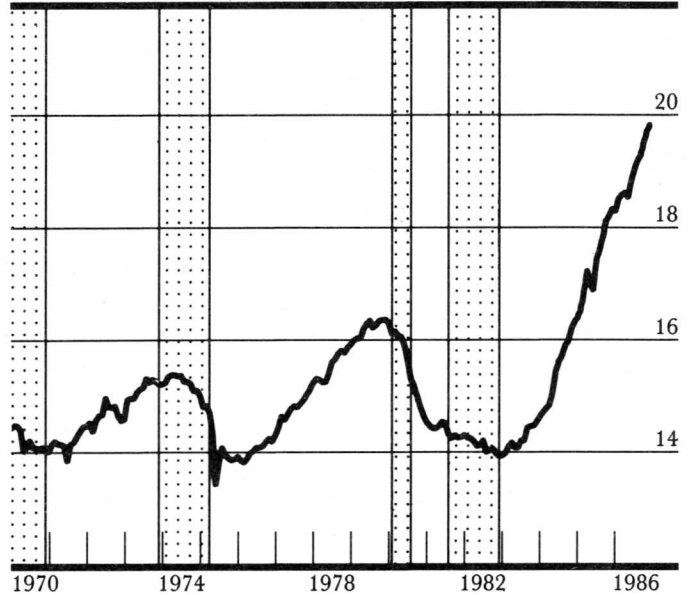
effects of the sharp decline in market interest rates on incentives to hold both NOW accounts and demand deposits. Since their peak in the latter part of 1984, short-term interest rates have fallen about 5 percentage points to their lowest levels in nine years, while NOW account rates have changed considerably less. Although more rapid money growth generally would be expected in an environment of declining rates, the expansion of M1 last year and in 1985 was in excess of what would be indicated by the historical relationships among money, interest rates, and income.

Domestic nonfinancial debt expanded almost 13 percent last year, a slightly slower pace than in the two previous years but still above both the Committee's monitoring range and the growth of nominal GNP. Debt issuance by the state and local sector dropped off substantially from the pace set in 1985, when it was boosted by borrowing in anticipation of tax reform restrictions.

The Household Sector

The expansion of household debt slowed last year as the growth of consumer installment credit receded to about 12 percent from the 15 to 20 percent pace of recent years. Nevertheless, installment debt continued to grow faster than income, and the ratio of such debt to income established another record. With mortgage debt expanding rapidly, the ratio of overall household debt to income also reached a new high. While assets of the household sector have increased sharply in recent years, many individuals have experienced difficulty in meeting their financial commitments.

Consumer Installment Credit As a Percent of Personal Disposable Income



The Business Sector

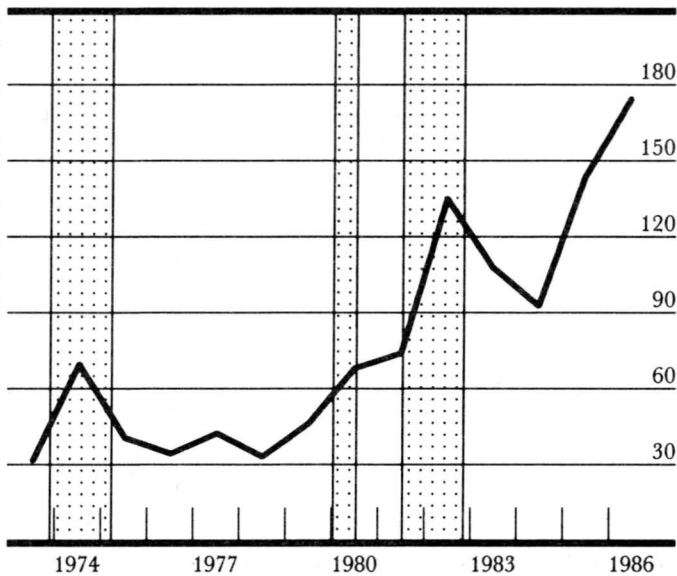
As long-term interest rates declined last spring to their lowest levels in eight years, the volume of corporate bond issuance surged to record levels. Indeed, the volume of domestic corporate bonds sold last year was nearly twice the previous record set in 1985. Much of the bond issuance last year was used to refund higher-cost debt or to pay down short-term credit. With the stock market continuing to register impressive gains last year, new equity issuance also reached record levels. Of the gross proceeds from new equity issues sold last year, about 30 percent was raised by firms issuing stock in the public market for the first time.

The retirement of high-coupon bonds, the reduced dependence on short-term credit, and the issuance of new equity shares tended to improve conventional measures of corporate balance sheet strength. However, massive volumes of outstanding equity were retired through mergers, acquisitions, buyouts, and other restructurings, resulting in the third consecutive year of large net equity retirements.

Because of the large paydown of equity, the ability of some corporations to weather economic shocks has waned. The weak financial structures of some firms, along with strains in certain industries, led to more than \$3 billion of corporate bond defaults in 1986, an amount that dwarfs the experience in nearly every other year of the postwar period.

While the economy has grown continuously for more than four years, the expansion has been uneven and has left certain sectors under severe strains. The problems faced by firms in the mining, energy, agricultural, and many manufacturing industries are well known, as are those of a number of heavily indebted developing countries. The difficulties in these areas are feeding through to the financial intermediaries supplying them credit. Last year, for example, 136 commercial banks failed—compared with a total of only seven in 1981. Many of these institutions had heavy credit exposures to the oil industry, while more than 40 percent of the failed banks held large amounts of agricultural loans.

**Number of Downgradings
in Moody's Corporate Bond Ratings***



*The number of downgradings on a corporation's highest-ranking debt issues. In April 1982, Moody's increased the number of rating categories by dividing most of its major categories into three subcategories. Only downgradings from one major category to another are counted.

The Thrift Industry

The financial condition of the thrift industry as a whole has improved markedly since the early part of the decade, but the difficulties of many institutions have intensified. As interest rates fell from their elevated levels in 1981 and 1982, the average cost of funds at thrift institutions declined much more rapidly than the average yield on their assets. The industry as a whole returned to profitability in 1983, and aggregate earnings have jumped since then. Net income for the industry in 1986 probably was strong again, although it is likely to have been below that in 1985.

At the same time, asset quality problems have become increasingly important for a sizable number of these institutions. While some of these problems are associated with economically distressed regions of the country, overly aggressive investment strategies of some institutions certainly have contributed heavily. For 1986, about one-quarter of the thrift industry will report negative net income, and the long-term prospects for many of these institutions are unfavorable. Moreover, the Federal Savings and Loan Insurance Corporation has inadequate resources to manage these problems effectively.

Regulatory and Supervisory Functions

While the many stresses and financial vulnerabilities are not amenable to correction through general monetary policy, they do influence the economic environment and represent a potentially disruptive and destabilizing element in the picture. The Federal Reserve has been called upon to play a positive role through its regulatory and supervisory functions. For example, steps have been taken to reduce the risks associated with large payments made by wire transfer, and several proposals have been made to ensure the capital adequacy of commercial banks. Many of the financial and sectoral stresses will take considerable time to alleviate, and will require a stable monetary environment, redress of the imbalances in the nation's federal budget and international trade positions, and—importantly—prudent private behavior, encouraged as necessary by sound regulation.

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.

2. M1, M2, and M3 incorporate effects of benchmark and seasonal adjustment revisions made in February 1987.

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

4. M1 figure in parentheses is the annualized growth rate from the second to the fourth quarter of 1985.

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

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