

1988

MONETARY POLICY OBJECTIVES

Summary Report of the Federal Reserve Board

February 23, 1988

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Summary Report to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978. February 23, 1988.

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Monetary Policy and the Economic Outlook for 1988

The national economy has scored major gains in the past year. Growth of real gross national product at 3¾ percent over the four quarters of 1987 outstripped most expectations, and the unemployment rate dropped below 6 percent for the first time in this decade. With such sectors as agriculture, mining, and manufacturing benefiting considerably from an improved competitive position internationally, the expansion of the economy was better balanced than in 1985-86. Wage increases remained moderate and contributed to favorable cost trends in many sectors. However, a rebound in oil prices, coupled with the effects of the dollar's decline on the prices of imported goods generally, pushed the rate of price inflation back up to the 4 percent range by most measures.

At times last year, soaring commodity prices, sharp declines in the dollar, and bond prices signaled the possibility of greater inflationary dangers. With the economy moving toward higher levels of resource utilization, the Federal Reserve had to be especially alert to these and other indications of pressures that might have led to a significant departure from the longer-run trend toward price stability. In these circumstances, monetary policy was characterized by a tendency toward greater restraint through last October. This was reflected in a moderate rise in money market interest rates, which in turn damped growth of the monetary aggregates. While M3 grew at a pace equal to the lower bound of the range set for the year by the Federal Open Market Committee (FOMC), M2 fell short of its range. After the plunge in the stock market in October, the System focused its efforts primarily on ensuring adequate liquidity in the economy, and since that time interest rates have reversed a good part of the rise that occurred earlier in 1987.

However, conditions in financial markets have yet to return fully to "normal," and the edginess of participants continues to be reflected in volatility and fairly sizable risk premia. Moreover, there have been some signs of weakness in the economy recently. In particular, the fourth quarter of 1987 was marked by a sharp rise in inventories in a few sectors, and there were indications of a slackening in labor demand early this year. Against this backdrop,

the System eased the pressures a bit further on reserve positions of depository institutions in the past several weeks.

But while the Federal Reserve has had to be responsive to the risks of an economic downturn, it has not lost sight of the potential influence of policy actions on longer-term trends in the economy. The United States is in the process of an important readjustment in the balance of economic activity, after a period of several years in which growth of domestic spending outstripped the pace of domestic production. Over that span, the trade balance moved into deep deficit, and the nation began to amass a huge net external debt. It is important to allow room for a significant improvement in our trade balance, especially given that high rates of capacity utilization and low unemployment, evident in many segments of industry, suggest the need for added care in maintaining progress toward price stability.

These considerations underlay the decisions of the Federal Open Market Committee when it met earlier this month to chart its monetary policy strategy for 1988. Such considerations also must be kept in the forefront as decisionmakers elsewhere in the government set policy. In particular, continuing fiscal restraint is crucial if we are to free up resources to finance productivity-enhancing private investment while bringing about an improved pattern of international transactions. Moreover, additional efforts at bringing greater coherence to policies, domestically and internationally, will promote greater stability in financial markets and greater internal and external balance to the economy.

Monetary Policy Plans for 1988

For 1988, the Committee set ranges of 4 to 8 percent for growth of M2 and M3. Expansion of money within these ranges, whose midpoints are one percentage point lower than those of the ranges for last year, would be expected to support economic growth at a pace that is consistent with continued external adjustment and progress over time toward price stability.

Ranges of Growth for Monetary and Debt Aggregates¹

Percent change, fourth quarter to fourth quarter

	1988	1987
M2	4 to 8	5½ to 8½
M3	4 to 8	5½ to 8½
Debt	7 to 11	8 to 11

Decisions regarding the ranges for money and credit growth in 1988 were shaped in part by the experience of 1987. Last February, the FOMC established annual target ranges of 5½ to 8½ percent for both M2 and M3; both aggregates had increased more than 9 percent in 1986, but slower growth was expected to be consistent with the Committee's goal of sustaining business expansion while maintaining long-run progress toward price stability.

The deceleration proved sharper than anticipated, and in July, the Committee stated that growth for the year around the lower ends of these ranges, or even below them, might be acceptable in certain circumstances. Velocity had increased in the first half of the year partly under the influence of rising interest rates, and the Committee agreed that if inflation forces were to exhibit renewed strength and interest rates were to increase further in the second half of the year, continued slow money expansion might be appropriate. Rates did move upward again in the late summer, including an increase of 1/2 percentage point in the discount rate to counter potential inflation. M2 growth did in fact fall substantially short of the Committee's range, at 4 percent for the year, while M3 growth, at 5½ percent, was at the lower end of its range.

In light of the experience of recent years, which have been marked by large swings in velocity, the ranges for 1988 were widened somewhat. There is continuing "noise" in the relationship of money growth to economic activity; in addition, velocity of money is sensitive to changes in market rates of interest. This sensitivity means that even small changes in rates, caused by variations in spending or prices, can have sizable effects on the quantity of money the public wishes to hold. Combined with an uncertain outlook for the economy and inflation, this implies that wider ranges are needed to encompass possible outcomes for monetary growth consistent with satisfactory economic performance in 1988. Thus, while the Committee at this time expects that growth of M2 and M3 will be around the middle of their ranges, the outcome could differ if significant changes in interest rates are required to counter unanticipated weakness in aggregate demand or an intensification of inflation. In carrying out policy, the Committee will continue to assess the behavior of the aggregates in light of information about the pace of business expansion and the source and strength of price pressures, with attention to the performance of the dollar on foreign exchange markets and other indicators of the impact of monetary policy.

The FOMC will continue to monitor the growth of debt in 1988. The expansion of the debt of domestic nonfinancial sectors is expected to slow somewhat from the 9½ percent pace of 1987, to around the middle portion of a 7 to 11 percent range. Growth of debt however, appears likely to outpace that of income, as it has for the past several years. Although the debt of governmental units may not grow as rapidly as it did last year, continued rapid expansion of private debt is probable, unless the current tide of corporate restructurings ebbs.

The Committee decided not to establish a range for M1 in 1988. It is especially difficult to anticipate the relationship between growth in this aggregate and the performance of the economy. The character of this aggregate had been affected more than the broader monetary aggregates by deregulation, because it now contains a large volume of interest-earning accounts that serve as savings as well as transactions vehicles.

Economic Projections

The uncertainties attending the present economic situation are reflected in a considerable range of forecasts among Committee members and other Reserve Bank presidents. However, the central tendency ranges encompass the vast majority of forecasts and point to growth in real GNP of 2 to 2½ percent in 1988.

This pace of activity would be expected to generate appreciable gains in employment over the year—about in line with labor force growth—and the civilian unemployment rate is projected to change little on balance between now and the end of 1988. Prices, as measured by the implicit price deflator for GNP, are expected to rise 3¼ to 3¾ percent, not appreciably different from the pace last year; consumer prices likely will increase a little faster than the deflator. The central tendency forecasts encompass the Administration's projections for real GNP, but are a bit more optimistic on prospects for price inflation.

Higher real net exports of goods and services are expected to provide a major impetus to U.S. economic activity in 1988. As reflected by the rapid growth of real exports of goods and services of more than 15 percent last year, the international competitiveness of U.S. producers has improved signifi-

cantly. By and large, U.S. manufacturers have let the foreign currency prices of their products decline with the depreciation of the dollar, achieving enhanced profitability through greater volume and aggressive efforts to increase efficiency and control costs. This enhanced competitiveness is expected to provide a further boost to export growth this year, while the increases in the relative prices of foreign goods apparently now in train should curb import growth. As a result, some improvement in the nation's current account balance is anticipated this year.

In contrast, domestic demand is expected to remain relatively subdued in 1988, as the economy moves toward a better balance between domestic spending and domestic production. Consumer demand probably will be damped to a degree by the loss of household wealth associated with the decline in stock prices last fall. Some increase in personal saving would be beneficial to the economy, as it would aid investment and help reduce our dependence on foreign capital. However, a severe retrenchment by consumers could have a significant deflationary effect; fortunately, the indications from surveys of household attitudes are that the sharp drop in confidence that occurred immediately after the October shock has been substantially reversed. Housing activity should pick up some in coming

Economic Projections for 1988 (percent)

		FOMC Members and other FRB Presidents		Administration
		Range	Central Tendency	
Change, fourth quarter to fourth quarter:	Nominal GNP	4 to 6½	5¼ to 6	6.4
	Real GNP	1/2 to 3	2 to 2½	2.4
	Implicit deflator for GNP	2½ to 4	3¼ to 3¾	3.9
Average level in the fourth quarter:				
	Civilian unemployment rate	5½ to 6¾	5¾ to 6	5.8*

*Overall unemployment rate.

months as a result of the recent decline in mortgage rates. In addition, business spending on plant and equipment should be buttressed by the desire to build upon the progress made in regaining international competitiveness and by already high levels of capacity utilization in a number of major industries.

Although real GNP should rise moderately for the year as a whole, the pattern of growth may be uneven over time. An adjustment to the runup in inventories that occurred in the fourth quarter of 1987 could produce relatively slow output growth during the first part of the year. Such an adjustment appears in process in the auto sector, in light of domestic automakers' current assembly schedules. There may also be similar patterns in a few other sectors, but at this time there are no signs that deep cutbacks in production will be necessary.

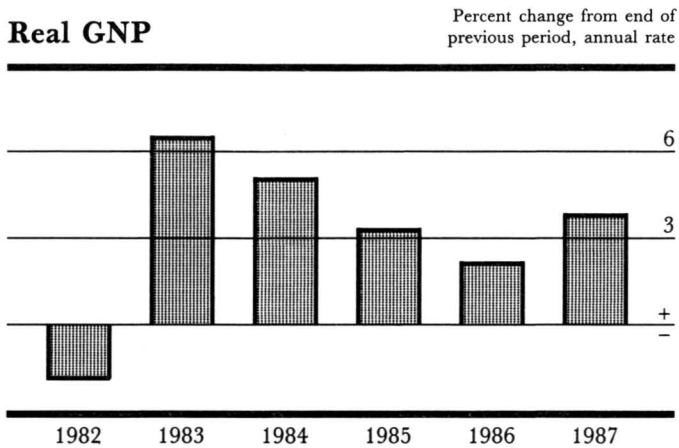
Although no significant change is anticipated in the overall pace of inflation this year, the primary source of the rise in prices is likely to change. Assuming relative stability in world oil prices, domestic energy prices should increase only a bit this year after their sharp rebound in 1987. However, prices of non-oil imports likely will continue to rise substantially further in the wake of the decline in the foreign exchange value of the dollar in 1987, providing continuing impetus to domestic inflation. This impulse to prices associated with the dollar's

depreciation is an unavoidable component of the process of correcting external imbalance, as an increase in the relative price of foreign goods encourages exports and discourages imports. However, if we are to maintain and extend the progress made in the 1980s toward price stability, it is crucial that business and labor continue to exercise restraint in price and wage behavior. The forecasts of the FOMC members and other Reserve Bank presidents anticipate that such a pattern will persist through this year. It is important, too, that the Congress remain mindful of the effects of legislation on the cost structure of American industry.

The forecasts of the Federal Reserve policymakers also assume 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 to an improved pattern of international transactions. It is critical that the package of deficit-reduction measures for 1988 and 1989—agreed to in December—be fully implemented.

The Performance of the Economy during the Past Year

The economy completed a fifth consecutive year of expansion in 1987, with real gross national product increasing about 3 ¼ percent over the four quarters of the year.* The overall growth in output not only was greater than in 1986, but was better balanced across industries and regions of the country. In addition, the rise in activity supported a net gain of more than three million jobs last year, and the civilian unemployment rate stood at 5.8 percent in January of this year, nearly a percentage point below its level a year-ago.



Virtually all broad measures of inflation—after dropping sharply in 1986—rebounded in 1987 to about the pace seen in 1984 and 1985. In large part, the pattern of price movements over the past two years reflected developments in oil markets, where prices rebounded last year after a sharp drop in 1986. However, prices also rose sharply for some imported consumer goods and, at the producer level, for a number of industrial commodities. In contrast, wage trends remained restrained last year, although tightening labor markets and the faster pace of inflation stemmed the pattern of wage deceleration evident in previous years.

A number of sectors that had been depressed in recent years began to show signs of improvement in 1987. The turnaround was most pronounced in manufacturing, where production and employment, especially in capital goods and industrial materials industries, picked up sharply, both in response to stronger orders from abroad and to higher levels of capital spending by domestic producers. However, improvement also was apparent in the domestic energy sector, where, in response to the partial recovery in oil prices, oil drilling retraced a small part of its earlier precipitous decline. Higher exports and continued federal support in agriculture boosted farm income and helped bring about some firming in land prices.

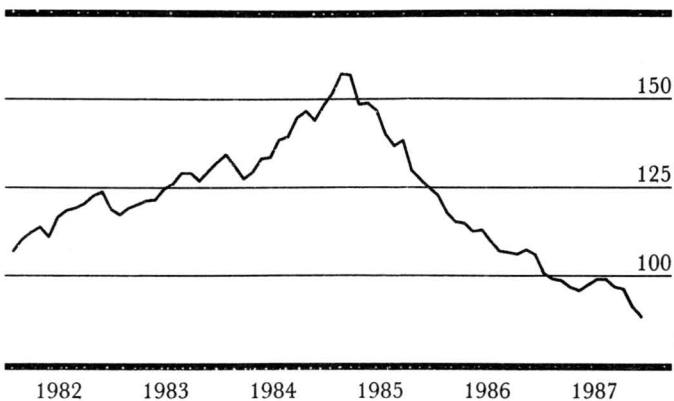
The improvement in economic conditions last year could be traced to the effects of increased competitiveness on the volume of imports and exports. Nevertheless, the combination of a substantial increase in the value of oil imports and rising prices of non-oil imports more than offset an improvement in real net exports, and the nominal trade deficit widened to almost \$160 billion in 1987. In addition, a further erosion of net income on investments and other service transactions pushed the current account deficit above \$160 billion.

Although economic activity rose at a brisk pace for 1987 as a whole, the October stock market crash added substantial uncertainty to the prospects for continued economic growth at year-end. The sharp drop in stock prices reduced household wealth considerably, raising the possibility of a further slowing in consumer spending, domestic business investment, and housing construction.

*Except where noted, all percent changes are from the fourth quarter of the previous year to the fourth quarter of the year indicated.

Foreign Exchange Value of the U.S. Dollar*

Index, March 1973 = 100



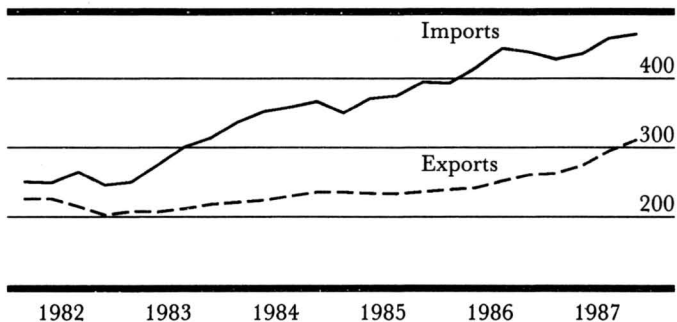
*Index of weighted average exchange value of U.S. dollar in terms of currencies of other G-10 countries plus Switzerland. Weights are 1972-76 global trade of each of the 10 countries.

The External Sector

The dollar depreciated by 14 percent in nominal terms over the course of 1987 relative to a trade-weighted average of the currencies of the other G-10 countries, leaving the dollar by the end of the year at a level almost 45 percent below its February 1985 peak and close to its 1980 low. The decline in the exchange value of the dollar was resisted by substantial official intervention purchases of dollars and an apparent movement of differentials in long-term real interest rates between the United States and major foreign countries. Nonetheless, some depreciation in the dollar evidently was seen by participants in foreign exchange markets as a necessary element in the adjustment of the huge U.S. current account deficit.

U.S. Real Merchandise Trade

Annual rate, billions of 1982 dollars



The U.S. merchandise trade deficit widened for 1987 as a whole, but leveled off on balance in the latter part of the year. The volume of imports increased, reflecting a moderate expansion in both oil and non-oil imports. Moreover, non-oil import prices moved up further in response to the continuing decline in the dollar through 1987, and, with oil prices also up sharply, imports rose substantially in value terms. Higher imports were matched, to a large extent, by merchandise exports, which also grew briskly in 1987.

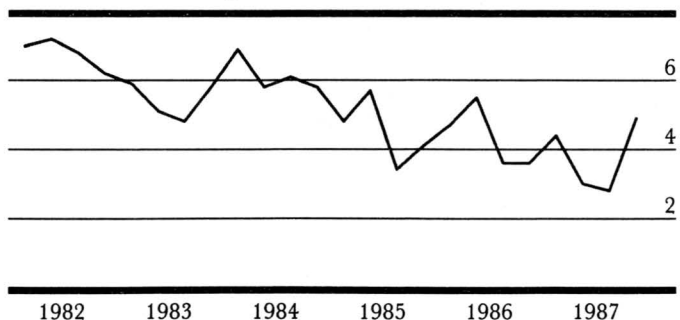
Economic expansion abroad strengthened slightly in 1987, providing only limited support for the improvement in the U.S. trade position. In the other industrial countries, economic activity picked up somewhat by the middle of the year after a slow start, but on average real GNP grew less than 3 percent over the year.

The Household Sector

Spending by households, which had been a major contributor to growth in past years, slowed considerably in 1987. Real consumer spending rose less than 1 percent last year, after a 4 percent gain in 1986.

Personal Saving Rate

Percent of disposable income



In large part, the cutback in spending reflected smaller increases in real disposable income. Substantial employment growth and increases in farm and interest income fueled continued gains in nominal incomes. However, a pickup in consumer price inflation eroded much of that rise and reduced real income growth to about 2 percent last year, versus 3½ percent in 1986.

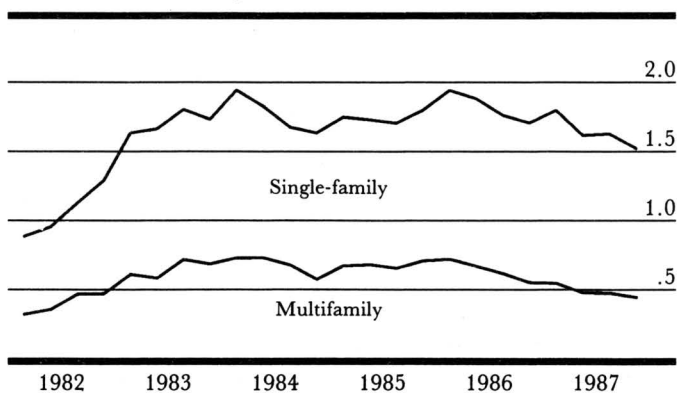
In general, consumers cut back their expenditures for both durable and nondurable goods, while spending on services continued to increase at about the pace of recent years. Within the durables category, sales of new cars fell from 11½ million units in 1986 to about 10¼ million units last year. Some of that dropoff can be traced to an especially slow pace of sales in early 1987, as consumers shifted automobile purchases into 1986 to take advantage first of major sales incentives and then of the sales tax deduction available only under the old tax law.

Associated with the more cautious spending patterns of consumers in 1987 was a slowing in household debt accumulation. Consumer installment debt decelerated sharply because of high debt burdens of households and a shift toward home equity loans in response to the new tax law.

Housing starts totaled 1.62 million for the year as a whole, about 10 percent below the 1986 total and the lowest in five years. Single-family homebuilding began the year at a brisk pace, but weakened considerably as conventional mortgage interest rates rose beginning in April, reaching about 11½ percent for fixed-rate loans by mid-October. Although interest rates on mortgages have dropped substantially since then, the stimulative impact of that change on housing demand may have been offset thus far by stock market losses and reduced consumer confidence. In the multifamily market, activity also weakened over the past year, as near record-

Private Housing Starts

Annual rate, millions of units, quarterly average



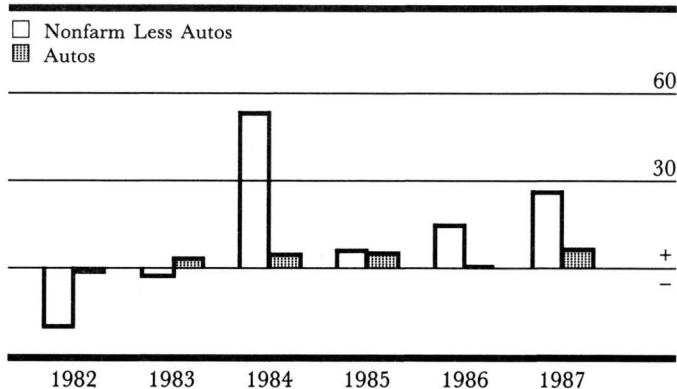
high vacancy rates on rental units and tax-law changes reduced the profitability of rental housing and continued to deter building in that sector.

The Business Sector

Business spending on plant and equipment rose about 3¾ percent in real terms in 1987. In large part, investment spending was associated with the overall pickup in economic activity. However, financial conditions also were conducive to spending, with cash flows strong and the costs of external capital fairly attractive through much of the year.

Changes in Real Business Inventories

Annual rate, billions of 1982 dollars



For equipment, the year began on the weak side, with first-quarter spending down sharply after firms shifted expenditures into late 1986 to take advantage of the favorable treatment of investment under the depreciation provisions of the old tax law. However, investment in equipment rebounded sharply in the second and third quarters of last year.

Outlays for nonresidential structures also turned up last year after a sharp drop in 1986. Much of the turnaround in spending reflected an improvement in the energy sector in response to higher oil prices.

Business inventory investment generally moved in line with sales over most of 1987, but a sharp accumulation of stocks in the fourth quarter suggested the possibility of excess inventory levels at some retailers. In manufacturing, inventories changed little on balance over the first half of the year, but rose considerably in the second half as activity picked up. Stockbuilding was most evident in capital goods industries, where orders and shipments strengthened substantially, as producers added supplies in anticipation of higher production levels. In the retail trade sector, inventories of goods other than automobiles also rose over the year, pushing the inventory-sales ratio to a relatively high level by December. The accumulation was most pronounced for home goods such as furniture and appliances and for apparel. At auto dealers, stocks generally rose in 1987, and, at year-end, supplies appeared to be well above desired levels despite the prevalence of special incentive programs and production cutbacks late in the year.

The Government Sector

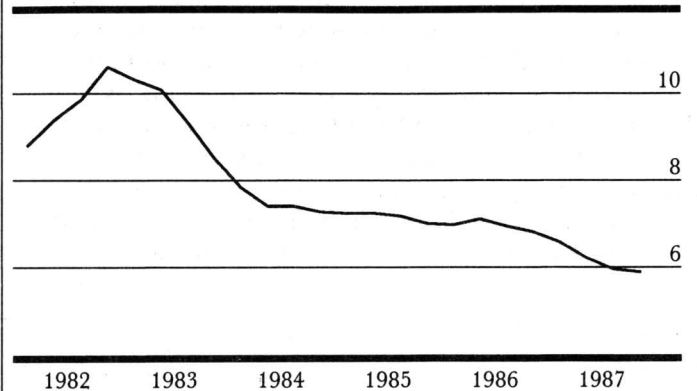
Last year, there was significant progress toward reducing federal budget deficits. The FY 1987 deficit, at \$150 billion, was about a third lower than the record level of the previous year. The Administration and Congress reached agreement on deficit reduction actions totaling more than \$30 billion in FY 1988 and about \$46 billion in FY 1989. However, a number of factors that raised receipts and lowered outlays in FY 1987 are not likely to be repeated, and—absent further legislative action—deficits could expand again unless there are particularly favorable economic circumstances.

Labor Markets

Employment increased three million over the 12 months of 1987, as the pickup in economic activity led employers to add workers at a brisk pace. In contrast to prior years when the labor market was characterized by sharp disparities across sectors, the strengthening in hiring in 1987 was widespread by industry. In manufacturing, employment edged up over the first half of the year and then rose substan-

Civilian Unemployment Rate

Quarterly average, percent

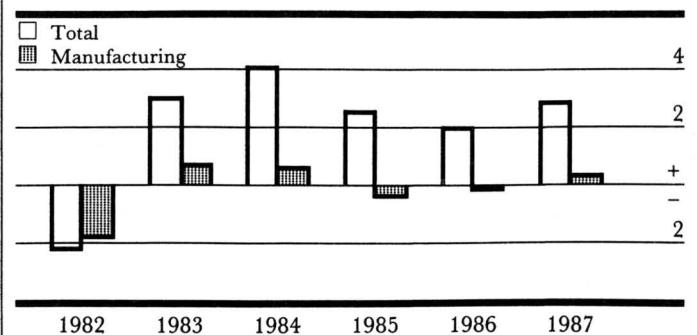


tially in the second half in response to the sharp gains in industrial production. Moreover, the expansion of jobs in the trade, service, and finance industries remained sizable during most of 1987. Hiring in trade and finance apparently slowed in the latter part of the year in the wake of sluggish consumer spending and the stock market crash.

The demand for labor considerably outpaced increases in labor supply, and the civilian unemployment rate dropped nearly 1 percentage point over the year to 5¾ percent at year-end—the lowest level since 1979. The jobless rate for adult men moved down to about 4½ percent by the end of last year, reflecting strong growth in the industrial sector. The rate for adult women fell to around 4¾ percent early in the year, but changed little in the second half.

Nonfarm Payroll Employment

Net change, millions of dollars, annual rate



Unit labor costs in the nonfarm business sector rose only 1¼ percent last year, after a 2 percent increase in 1986. The continued restraint in labor costs primarily reflected moderate compensation growth, as productivity gains for the sector as a whole have improved little from the sluggish pace of the 1970s. In contrast, manufacturers apparently have made significant progress in increasing efficiency and streamlining operations, and output per hour in this sector rose nearly 3½ percent in 1987.

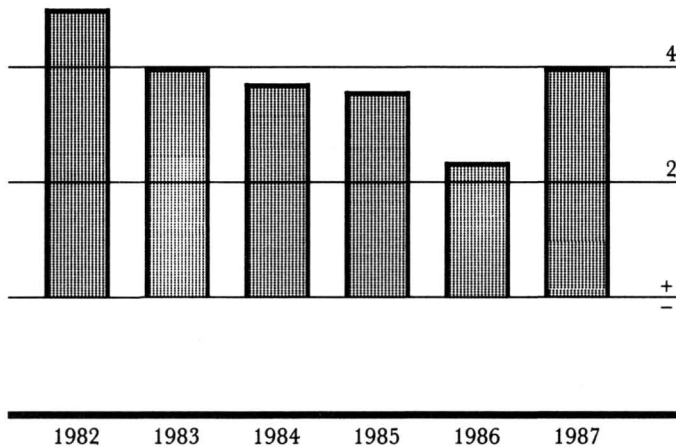
Price Developments

Inflation rebounded in 1987, largely reflecting higher energy prices and continued price hikes for imported goods. The fixed-weighted price index for GNP increased about 4 percent for the year as a

GNP Prices

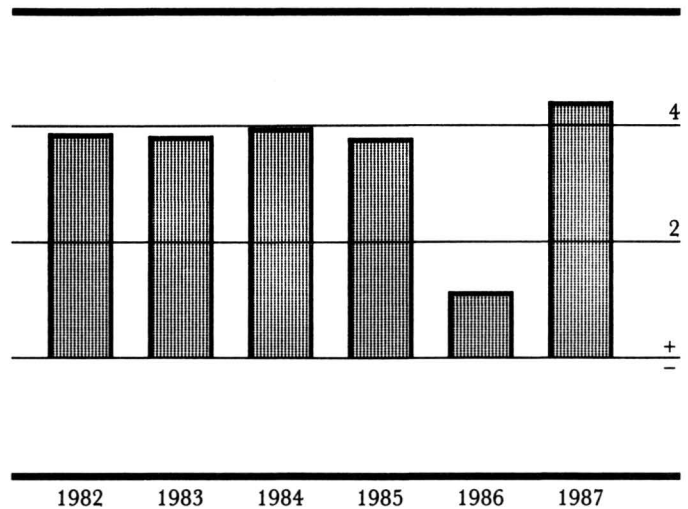
Percent change from end of previous period, annual rate

Fixed-weighted Price Index



Consumer Prices*

Percent change from end of previous period, annual rate



*Consumer Price Index for all urban consumers.

whole, after a 2¼ percent rise in 1986. The consumer price and producer price indices suggested an even sharper acceleration in prices over 1987, owing to the greater importance of energy in those indices. The consumer price index was up 4½ percent in the 12 months ended December, after a 1 percent rise in 1986. The producer price index, which only includes prices of domestically produced goods, rose 2¼ percent over the year, after dropping 2¼ percent in 1986.

Prices for many industrial commodities also rose considerably in 1987. In addition to the increase in crude oil prices, copper prices more than doubled last year, and steel scrap prices were up 36 percent. To some extent, the sharp rise in commodity prices reflects the influence of dollar depreciation on markets for internally traded goods.

Monetary Policy and Financial Markets in 1987

While the Federal Open Market Committee set targets for some of the monetary aggregates, it was deemed necessary to maintain a flexible approach in conducting its operations. The Committee looked at a broad range of information in judging when or if to adjust its basic instruments—reserve availability and the discount rate—in response to deviations in monetary growth from expected rates. Such factors as the pace of business expansion, the strength of inflation and inflation expectations, as well as developments in exchange markets, played a major role in governing the System's actions. In light of the behavior of these other factors, growth in the targeted aggregates, M2 and M3, was permitted to run at or below the established ranges.

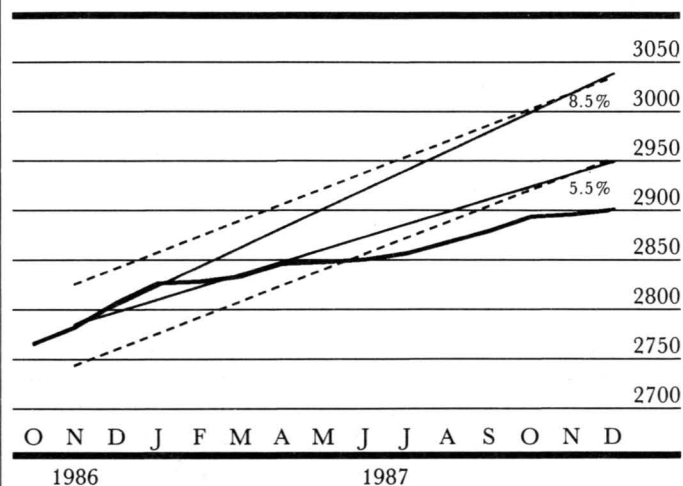
During episodes beginning in the spring and then again in late summer, the dollar came under sustained downward pressure and inflationary expectations appeared to be on the rise, partially in response to the dollar's weak performance. With the economy expanding at rates sufficient to produce rising rates of resource utilization, the FOMC sought some firming of pressures on reserve positions and increased the discount rate in September. When stock prices collapsed in mid-October, the resulting turmoil required that the focus of policy be on ensuring the liquidity of the financial system. Over the remainder of the year, emphasis in the conduct of open market operations shifted toward maintenance of steady and somewhat easier money market conditions to promote a return of stability to financial markets generally and to cushion the effects of the stock market decline on the economy.

Behavior of Money and Credit

M2 increased only 4 percent in 1987, well below both the lower bound of its 5½ to 8½ percent annual growth range and its more than 9 percent rate of expansion over the preceding two years. The velocity of this aggregate picked up substantially, reversing a portion of the sharp decline that occurred in 1985–86. The rise in velocity may have reflected in part a number of special factors affecting the public's demand for M2 balances in 1987, including a much-reduced rate of saving out of income and a preference for drawing upon liquid assets—rather than using consumer credit—to

M2

Billions of Dollars

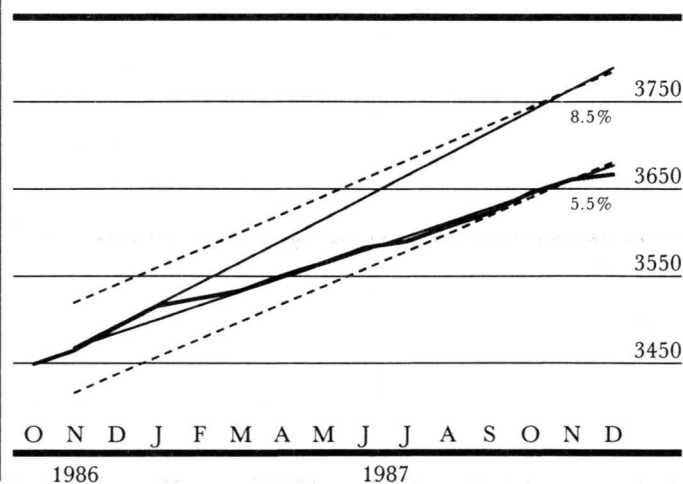


finance purchases. The latter preference occurred in the wake of tax reform measures which reduced the deductibility of nonmortgage interest payments. However, much of the pickup in velocity appears attributable to increases in the competing returns on other assets, which raised the opportunity costs associated with holding M2 balances.

M3 was stronger than M2 over the year, expanding 5½ percent and ending the year at the bottom of its 5½ to 8½ percent annual growth range. Its faster growth reflected heavy reliance by depository institutions on large time deposits and on certain other instruments included in M3 but not in M2.

M3

Billions of Dollars



Both commercial banks and thrift institutions stepped up their issuance of wholesale managed liabilities to fund more asset growth than could be accommodated by greatly reduced inflows of core deposits. Even so, M3 growth was subdued relative to prior years, reflecting in part reduced overall needs for funds as asset expansion at banks and thrifts slowed. In addition, banks relied heavily on managed liabilities obtained from non-M3 sources, especially funds borrowed from their foreign branches.

Growth of M1 slowed to 6¼ percent from the very rapid 15½ percent increase posted the previous year, owing to a small decline in demand deposits and a sharply lower expansion of other checkable deposits. The velocity of M1 increased slightly, after

a record postwar decline a year earlier. The sharp slowing of growth and the abrupt turnabout in its velocity are indicative of the increased sensitivity to movements in market interest rates that has emerged for M1 in recent years. As suggested by its comparatively larger deceleration in 1987, M1 now appears to have a greater sensitivity to changes in interest rates than the broader aggregates.

The debt of domestic nonfinancial sectors grew 9½ percent last year, ending the year at the middle of the Committee's monitoring range of 8 to 11 percent. Debt expansion moderated considerably from the 13¼ pace of the two previous years, but still rose faster than income.

Growth of Money and Debt (Percentage changes)²

Period		M1	M2	M3	Domestic Nonfinancial Debt
Fourth quarter to fourth quarter	1979	7.7	8.2	10.4	12.3
	1980	7.5	8.9	9.5	9.6
	1981	5.2 (2.5) ³	9.3	12.3	10.0
	1982	8.7	9.1	9.9	8.9
	1983	10.2	12.1	9.8	11.3
	1984	5.3	7.6	10.4	14.2
	1985	12.0 (12.9) ⁴	8.9	7.7	13.3
	1986	15.6	9.4	9.1	13.2
	1987	6.2	4.0	5.4	9.6
Quarterly growth rates 1987	Q1	13.2	6.5	6.5	10.5
	Q2	6.6	2.6	4.7	8.7
	Q3	0.8	2.8	4.5	8.1
	Q4	3.9	4.0	5.6	9.7

Implementation of Monetary Policy

During the first half of 1987, monetary policy was carried out in an atmosphere of increasing concerns about the course of inflation, arising in part from heavy downward pressure on the dollar. Growth of the economy was bringing about noticeable increases in resource utilization. Inflation was picking up, reflecting the effect of a weaker dollar on import prices as well as a rebound of oil prices from low 1986 levels. When the dollar came under heavy pressure in late March, previously tranquil credit markets began to exhibit concern about the effect that declines of the dollar would have on prices. Long-term interest rates, in particular, moved up strongly. In conjunction with some easing moves abroad, the Federal Reserve sought somewhat greater restraint in the provision of reserves to the banking system. Initially, this action produced further increases in interest rates, but subsequently, financial pressures eased somewhat. In response to reductions in interest rates abroad, to some flattening in commodity prices, and to better news on the U.S. trade deficit, the dollar firmed and there was a broad decline in interest rates, with long-term rates falling somewhat more than short-term rates.

When the FOMC met in July to review its growth ranges for money and credit, all of the monetary aggregates had decelerated considerably. The weakness in monetary growth did not reflect any evident weakness in the economy. Rather, the slower money growth, and accompanying strengthening in velocity, appeared largely attributable to the rise in market rates of interest fostered in part by the Federal Reserve's response to adverse developments with respect to the dollar and inflation. The Committee decided to reaffirm its 1987 growth ranges for M2 and M3; in doing so, it anticipated some pickup in the growth of M2 over the remainder of the year. It indicated that growth for all of 1987, near or even below the bottom of the target ranges, might be acceptable for both aggregates, depending on the behavior of their velocities and other financial and economic developments, notably the evolving strength of inflationary pressures. The Committee also decided not to set a

target range for M1, given the unpredictability of the behavior of this aggregate relative to economic activity.

For a short time after the July meeting, the dollar rose further, but with the release of trade data in mid-August that disappointed market participants, the dollar again came under substantial downward pressure. Long-term bond yields moved up sharply as the dollar's weakness against a backdrop of strength in the economy spurred concerns about inflation and possible firming of monetary policy. Interest rates in short-term markets also increased, but by lesser amounts. In light of the potential for greater inflationary pressures, in part related to weakness in the dollar, the Federal Reserve sought to reduce marginally the availability of reserves through open market operations; it also raised its discount rate by 1/2 percentage point in early September to 6 percent. After the discount-rate action, interest rates rose further, especially in short-term markets.

Stock prices, which had reached very high levels relative to earnings and had been falling since mid-August, plunged on October 19 in chaotic trading. The stock market drop prompted a marked decline in interest rates as investors sought refuge in the perceived safety of fixed-income assets, especially Treasury securities. Although most stock indexes recovered somewhat in the wake of the crash, financial markets remained turbulent, with bond and equity prices fluctuating widely.

In a financial environment of extraordinary turmoil and apparent fragility, the Federal Reserve shifted the emphasis in the conduct of open market transactions to providing reserves generously to ensure that adequate liquidity would be available to meet any unusual needs. This action helped to calm the financial markets, although conditions remained somewhat unsettled over the rest of the year.

Early in 1988, as incoming data suggested that economic expansion over the first part of the year might be weak, bond rates dropped substantially and the Federal Reserve sought some slight additional easing in desired pressures on reserve positions. Better trade news bolstered confidence in the dollar, and the monetary aggregates showed signs of renewed strength.

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 1988. Certain technical redefinitions affecting only M1 were made at the same time.

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.

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