Federal Reserve System -- Monetary Policy Report

Summary Report of the Federal Reserve Board [1989 Series]

1989 MONETARY POLICY OBJECTIVES

February 21, 1989

Federal Reserve System.
Board of Governors.

Summary of the Report of the Federal Reserve Board

1989 MONETARY POLICY OBJECTIVES

Reported to the Congress, pursuant to the Full Employment and Balanced Growth Act of 1978, on February 21, 1989.

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Monetary Policy and the Economic Outlook for 1989

Overall, 1988 was another year of progress for the U.S. economy, marked by further substantial increases in output and employment and by a significant improvement in the balance of trade. The dramatic stock market break of October 1987 did seem to affect real activity for a time, but the underlying strength of the economy soon showed through, and, apart from losses of farm output caused by the drought, growth proceeded at a relatively strong pace throughout 1988. Moreover, the sizable employment gains in January of this year suggest that the economy entered 1989 with considerable forward momentum.

Inflation has remained in check into the seventh year of the expansion. Even so, developments during 1988 were a little worrying, as, for a second year, increases in prices were somewhat larger than in earlier years of the expansion. Part of the pressure on prices in 1988 came in the food area and reflected the influence of drought. However, with labor markets tightening, there also was a quickening in the rise of wages and total hourly compensation, which affected prices more generally.

Federal Reserve policy mirrored the changing economic circumstances of 1988. Early in the year, as in late 1987, the Federal Reserve sought to limit repercussions from the plunge in stock prices and, in particular, to guard against the possibility of a significant contraction in business activity. Pressures on the reserve positions of depository institutions were eased a bit further in early 1988, and interest rates edged down for a time, extending the declines that had begun in October of 1987. Growth of M2 and M3 was fairly rapid during this period, nearly reaching the upper bounds of the target ranges.

A shift by the Federal Reserve toward restraint was reflected in a tightening of the reserve market conditions that began in late March and continued, in several steps, into 1989. Short-term market interest rates moved up during this period, influenced both by the System's tightening and the strength of the economy, and the discount rate was raised in August, to its current level of 6½ percent. Growth of M2 moderated after the spring and ended the year just below the middle of the 1988 target range. The growth of M3 also ebbed over the last two quarters, as the needs of banks and thrifts to fund credit expansion slackened.

By late February 1988, short-term interest rates were about 2½ percentage points higher than they were early last spring. Long-term interest rates, by contrast, have changed little, on net, over that same period. Although these rates turned up in the spring of 1988, they leveled off over the summer and edged down in the fall, even as short-term rates were continuing to rise. This behavior of bond yields seems to have reflected a lowering of market expectations of long-run inflation.

Monetary Policy for 1989

The commitment by the Federal Reserve to contain inflationary pressures is reflected in the Federal Open Market Committee's (FOMC) decisions to lower the ranges for monetary and credit expansion this year. The Committee has set a 3 to 7 percent range for M2 growth during 1989 and a 3½ to 7½ percent range for M3, reaffirming the ranges established tentatively in June 1988. These ranges were reduced from those for 1988—a full percentage point for M2 and 1/2 percentage point for M3. This signalled the Committee's determination to resist any upward tendencies in inflation in the coming year and to promote progress toward price stability over the long run. The monitoring range for growth of domestic nonfinancial debt for 1989 was set at 6½ to 10½ percent, which also is lower than that of last year.

Despite the deregulation of deposit interest rates, M2 velocity has remained very sensitive to changes in market interest rates over periods as long as a year or more. Depository institutions have been slow

Ranges of Growth for Monetary and Credit Aggregates[1]

(Percent Change, Fourth Quarter to Fourth Quarter)

	1987	1988	1989
M2	5½ to 8½	4 to 8	3 to 7
M3	5½ to 8½	4 to 8	3½ to 7½
Debt	8 to 11	7 to 11	6½ to 10½

to adjust some of their offering rates, causing substantial changes over the short and intermediate term in the relative attractiveness to savers of deposits versus market instruments. In these circumstances, the appropriate growth of M2 and the other aggregates in the coming year is difficult to specify in advance; it will depend on how interest rates are affected by the economy and prices and on the response of depository institutions to any changes in market interest rates, both of which are subject to a substantial degree of uncertainty.

In 1989, the behavior of M2 and M3 also could be influenced by the resolution of problems in the thrift industry, depending, in part, on how pricing practices of these institutions change, the reactions of retail and wholesale depositors in these institutions, and the extent of any restraints on the growth of assets of savings and loan associations.

Economic Projections

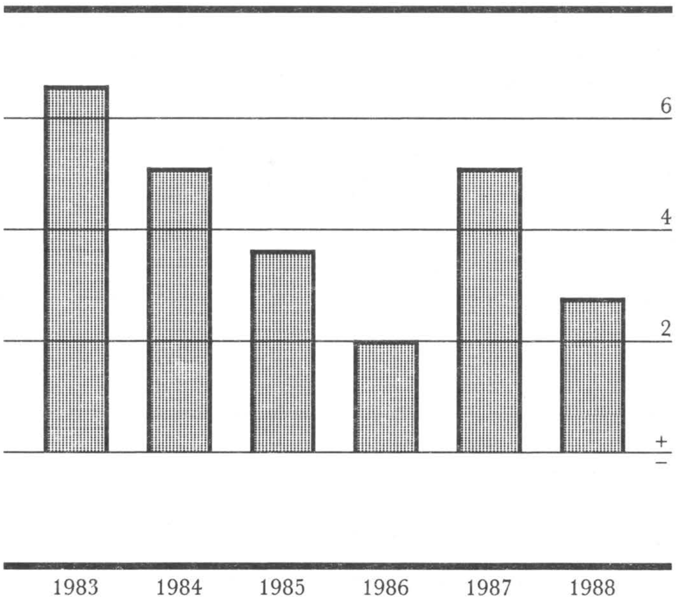
Board members and Reserve Bank presidents anticipate real GNP will grow moderately in 1989; prices will rise at a pace similar to, or perhaps slightly above, that of 1988; and the unemployment rate will remain near its recent level—the lowest in a decade and a half. On balance, the FOMC members anticipate a little less real growth and a somewhat higher rate of inflation than does the Administration, but the differences are not large.

Members of the Committee believe that the progress of the economy in 1989 will be determined in large measure by developments on the inflation front. Although special factors, such as the drought, contributed to price increases last year, there also have been troubling indications—most notably in recent wage trends—that inflationary pressures have become more widespread and, potentially, more deeply rooted.

Given the tightening actions taken by the Federal Reserve over the past year and the policy of continued restraint on aggregate demand expressed in the monetary targets for 1989, the members of the Committee anticipate that, if there is any further acceleration of prices from the 1988 pace, it will be quite limited. A particular uncertainty in the inflation outlook for 1989 centers on the prospects for food prices. FOMC members generally assumed that a return to more normal weather conditions this year, together with an increase in acres planted, would lead to a sharp rebound in crop production, in which case food prices might help to temper overall inflation. However, because stocks of some key

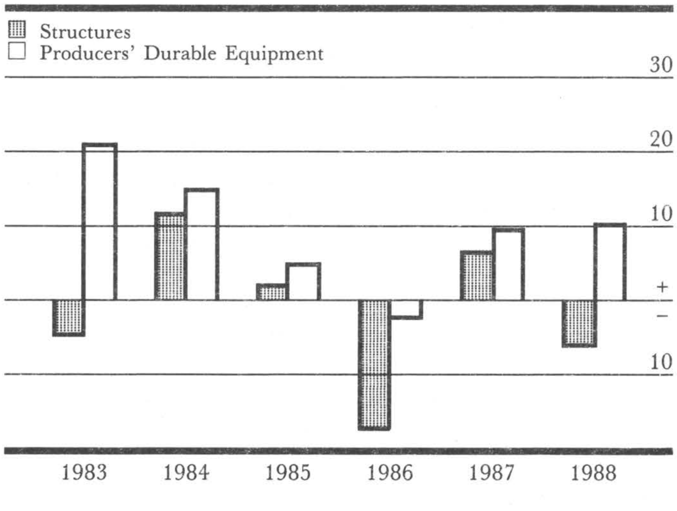
Real GNP

Percent change from end of previous period, annual rate



Real Business Fixed Investment

Percent change from end of previous period, annual rate



agricultural commodities have been reduced to low levels, there also is risk that another year of drought could generate strong upward pressures on prices. In the energy area, consumer prices could rise sharply early this year, responding to the runup in oil prices around the end of 1988. Nonetheless, world oil supplies still look ample, and members of the Committee are assuming that energy prices will increase only moderately over 1989 as a whole.

Although the economy clearly has entered 1989 on a strong note—even discounting the transitory influence of unusually mild weather in many parts of the country—the members feel that growth soon will move to a lower trajectory, owing both to the general influence of monetary restraint and to a number of trends in specific sectors.

In the business sector, the boom in capital outlays that was evident in the first half of 1988 has since abated, and surveys of plans for 1989 point to moderate gains in overall plant and equipment spending. Government purchases are expected to be held down by budgetary constraints; defense purchases, in particular, have been trending lower under the influence of cutbacks in real spending authority. Recent increases in mortgage rates likely portend some slackening in the pace of homebuilding after a surge in the final quarter of 1988. The growth of consumption expenditures also should begin to taper off from the rapid pace of 1988, as a slowing of expansion elsewhere in the economy damps the growth of real disposable income.

With regard to the external sector, real net exports of goods and services declined over the second half of 1988, but most members of the Committee expect some improvement in the months ahead. However, substantial further progress in external adjustment will require a continuing commitment on the part of U.S. firms to capitalize on the enhanced competitiveness resulting from the depreciation of the dollar since 1985. That commitment must take the form not only of continued cost control and price restraint, but also of more intense efforts at marketing abroad and investment in new capacity where constraints are visible. Failure on these counts would almost certainly leave the U.S. economy considerably less well off over the long haul.

Government policy can do much to encourage businesses to make the longer-range commitments needed to bring about better balance in the economy and to foster longer-run growth. A monetary policy directed steadfastly at movement toward price stability is one critical ingredient. But also crucial is action to bring about further progress toward balance in the federal budget. The Committee has assumed that Gramm-Rudman-Hollings targets will be adhered to in the fiscal 1990 budget process, but the creation of an environment favorable for economic growth with stable prices requires that fiscal policies be put in place to produce the prescribed budget results in the out-years as well.

Economic Projections for 1989 (Percent)

		1988 Actual	FOMC Members and other FRB Presidents	
			Range	Central Tendency
Change, fourth quarter to fourth quarter:	Nominal GNP	7.0	5½ to 8½	6½ to 7½
	Real GNP	2.7	1½ to 3¼	2½ to 3
	Consumer price index	4.3	3½ to 5½	4½ to 5
Average level in the fourth quarter:	Unemployment rate	5.3	5 to 6	5¼ to 5½

The Performance of the Economy in 1988

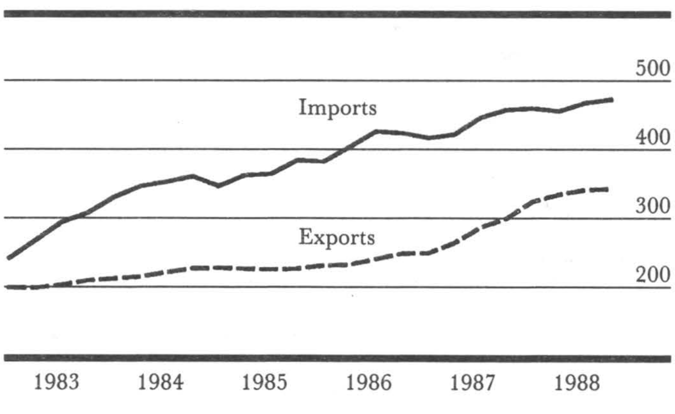
The U.S. economy completed a sixth year of expansion in 1988. Real GNP rose about 2¾ percent over the course of the year; the number of jobs increased more than 3½ million; and the unemployment rate remained on a downward course, closing the year at 5.3 percent, its lowest level in 14 years. Progress also was made toward restoring external balance, as the merchandise trade deficit fell sharply.

The year began on a note of uncertainty. The sharp break in the stock market in the fall of 1987 had raised concern that the economy might falter, and some signs of weakness did emerge around the start of 1988. By early spring, however, it became clear that the expansion still had considerable vigor, coming in particular from rising exports and a boom in capital spending. Households, meanwhile, adjusted fairly readily to the loss of stock market wealth, and consumer spending rose at a strong pace throughout the year. Toward the end of the year, net exports and capital spending softened, but there was enough impetus from other sectors to keep real GNP on a firm upward course.

The rate of inflation, which had picked up in 1987, remained somewhat higher in 1988 than in earlier years. The step-up in inflation in 1987 had resulted mainly from a rebound in the price of oil and the passthrough of higher prices for imports. This past year, by contrast, extra price pressures reflected the impact of drought on the price of food and, more generally, a widespread pickup in labor costs in the domestic economy.

U.S. Real Merchandise Trade

Annual rate, billions of 1982 dollars



The rise in real GNP last year would have exceeded 3 percent, but for a severe drought—one of the worst of this century—that caused huge losses of farm output. These losses accounted for most of the slowdown in GNP growth that occurred after the first quarter of 1988. Fortunately, inventories of farm products had been sizable coming into 1988, and a drawdown of stocks helped to buffer households and others from the disruption to output.

In most of the nonfarm economy, the growth of activity was robust in 1988. Production in the manufacturing sector increased 5 percent, nearly matching the previous year's gain, and factory employment rose sharply. Employment also continued to grow rapidly in retail and wholesale trade and among the providers of business and health services. However, oil drilling, which had turned up in 1987 when oil prices were rising, experienced renewed weakness in 1988, intensifying economic stresses in some parts of the country.

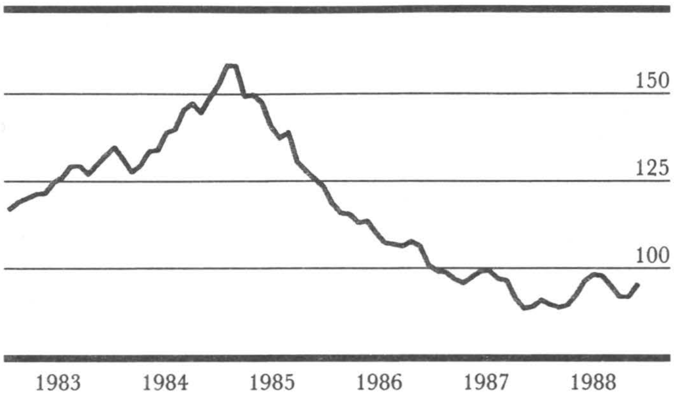
The External Sector

The U.S. external accounts showed considerable improvement during 1988. On a balance of payments basis, the deficit on merchandise trade fell from an annual rate of $165 billion in the fourth quarter of 1987 to around $120 billion in the second quarter of 1988 and, on average, remained at that lower level in the second half of the year. Over the four quarters of last year, the value of exports rose more than 20 percent; adjusted for inflation, the increase was around 15 percent.

The value of merchandise imports, other than oil, rose about 7 percent during 1988. The volume of non-oil imports increased about 2 percent. This rise was concentrated mainly in the capital goods area; volume was down for other major categories of imports. The value of oil imports declined last year, as an increase in physical volume was more than offset by a decline in price.

Foreign Exchange Value of the U.S. Dollar*

Index, March 1973 = 100



*Index of weighted average foreign 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.

For the first three quarters of 1988, the current account showed a cumulative deficit of $102 billion, which was balanced by recorded net capital inflows of $88 billion and a statistical discrepancy of $14 billion.

The foreign exchange value of the U.S. dollar, which had fallen sharply from early 1985 through the end of 1987, has shown wide fluctuations in the subsequent period. Measured against the other G-10 currencies, the dollar currently is up somewhat, on net, from its end-of-1987 low. However, it has declined in real (price-adjusted) terms against the currencies of our major trading partners among the developing countries, especially South Korea, Mexico, and Brazil.

The Household Sector

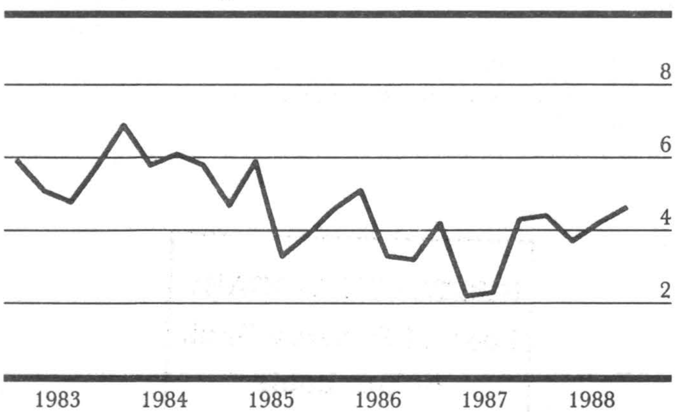
At the start of 1988, concern about the possible effect of the stock market break on the real economy centered on the household sector. The drop in share values had pared roughly half a trillion dollars from household wealth, and the degree to which spending would be cut in response to this loss of wealth was not clear.

In the event, the loss of wealth may indeed have left an imprint on consumer demand. The personal saving rate did rise after the crash and, over the next year, averaged about a percentage point higher than in the year preceding the crash. But, with exports and capital investment booming, the growth of jobs and real incomes remained strong in 1988, and the uncertainties spawned by the crash soon gave way to renewed optimism among households.

Real residential investment fell slightly in the first half of 1988, but turned up in the second half and, by the fourth quarter, was a little above the level of a year earlier. Starts of multifamily units, which had slumped in 1987, fell further in the first quarter of 1988, but then flattened out over the remainder of the year. Vacancy rates for multifamily dwellings remain high in many areas and are likely to hold down new construction of these units for some time. In the single-family sector, starts edged down through the first three quarters of 1988, but rebounded toward year-end to the highest levels since the fall of 1987.

Personal Saving Rate

Percent of disposable income



The Business Sector

Virtually all indicators of business activity exhibited strength in 1988. Business sales, in nominal terms, rose 9 percent over the year. Hiring was brisk in most sectors, and operating rates rose further. In the industrial sector, capacity utilization at the end of 1988 was at its highest level since 1979. Corporate profits remained healthy.

A surge in business equipment spending that had begun in 1987 extended through the first half of 1988, when outlays grew, in real terms, at an annual rate of about 20 percent. The surge was led by sizable investment in high-technology items—computers, communication equipment, and the like—but outlays for other types of equipment also were strong. Business spending for new construction declined in 1988, reversing the moderate increase of the previous year.

Inventory investment, which had been sizable in late 1987, moderated in 1988, and, with sales on an upward trajectory, stock overhangs were not a problem for most businesses.

The Government Sector

Budgetary constraints have led to a slowing of government purchases, both at the federal level and among state and local governments. The federal government's purchases of goods and services—the part of federal spending that adds directly to the gross national product—fell 4 percent in real terms from the fourth quarter of 1987 to the fourth quarter of 1988. Roughly half of the decline reflected a drought-induced reduction in the farm inventories owned or financed by the Commodity Credit Corporation (CCC), a reduction that is counted as a negative federal purchase. Excluding this inventory swing, federal purchases were down 2 percent over the year—the first decline since 1976.

On a budget basis, total federal outlays, which are almost three times as great as federal purchases alone, continued to rise in fiscal year 1988, but at a somewhat slower rate than in most previous years. There were further increases in entitlements, greater demands on deposit insurance agencies, and increases in net interest payments. Meanwhile, the growth of federal receipts slowed in 1988 from the rapid pace of the previous year. Receipts from social security taxes rose more than 10 percent—owing in part to a rate increase in January of 1988. However, growth in receipts from personal income taxes slowed, as increases in employment and nominal incomes were offset by final reductions in income tax rates legislated under the 1986 tax reforms. The federal budget deficit in fiscal year 1988 was $155 billion, slightly above the level of the previous year.

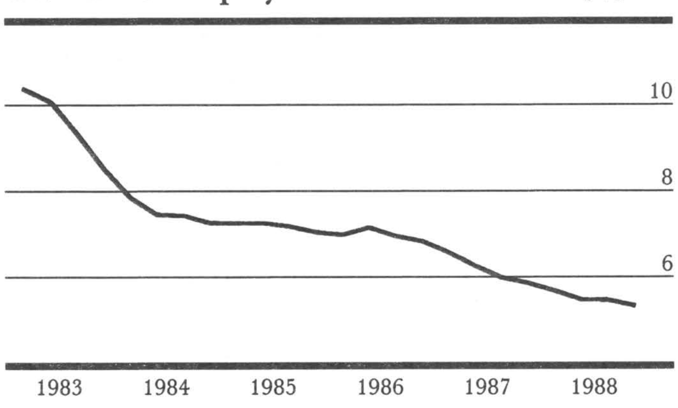
The real purchases of goods and services by state and local governments rose 3 percent over the four quarters of 1988, a little more than in 1987, but less than the average rate of growth over the preceding three years.

The Labor Markets

The rise in the number of jobs during 1988 was somewhat above that of 1987 and brought the total increase in payroll employment since late 1982 to about 18½ million. Virtually all parts of the economy shared in last year's gain. The number of jobs

Civilian Unemployment Rate

Quarterly average, percent



in manufacturing increased 400,000; employment in construction was up 300,000. Close to a million new jobs were created in retail and wholesale trade, and 1.3 million were added in services. Except for a brief slowdown in the summer, the growth of jobs was strong throughout the year.

The tightening of labor markets in 1988 was associated with a pickup in the rise of wages and labor costs. The employment cost index for wages and salaries in the private nonfarm sector increased a bit more than 4 percent over the year—almost a percentage point more than in 1987.

Productivity gains slackened somewhat in 1988. The rise in output per hour in the nonfarm business sector over the four quarters of the year was only 0.7 percent—about half a percentage point below the average over this decade.

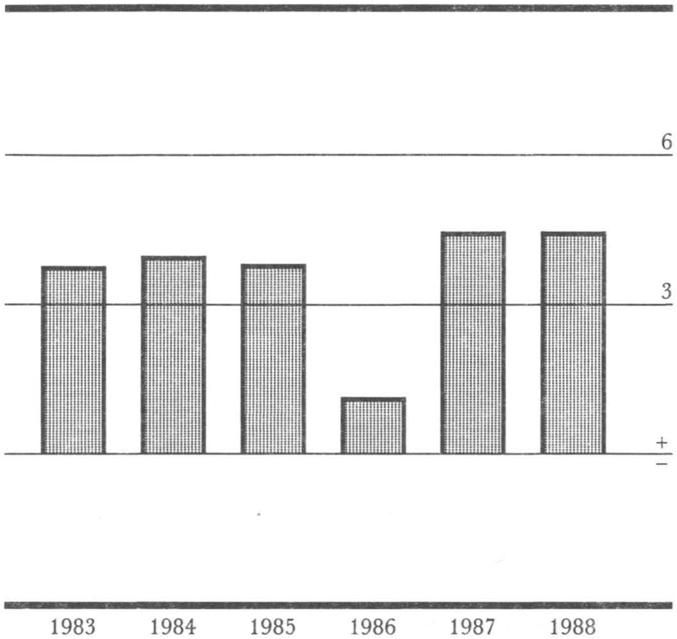
Price Developments

The broader measures of prices—including the GNP price measures, the producer price index, and the consumer price index—all indicate that inflation was in a range of 4 to 4½ percent in 1988. In contrast to 1987, when the indexes were boosted by a rebound in energy prices and rising prices for imports, the inflationary pressures this past year were augmented by larger increases in labor costs in the U.S. economy and the drought's influence on agricultural prices.

The drought's effects appeared quickly at the retail level in the summer, as price increases picked up for a wide variety of consumer foods. By late autumn, however, the impact of the drought on food prices began to dissipate, and inflation in the food sector returned to a more moderate path. The increase in consumer food prices over the year as a whole was 5¼ percent—about 2 percentage points above the average of the preceding five years.

Consumer Prices*

Percent change from end of previous period, annual rate



*Consumer Price Index for all urban consumers.

Energy prices were little changed at the consumer level during 1988 after a sharp rise in 1987—a pattern that resulted mainly from the continued gyrations in world oil markets. The price of oil, which had risen sharply in 1987, moved lower for much of 1988, as the efforts of OPEC to restrain production unraveled.

Price increases for goods and services other than food and energy were larger in 1988 than in 1987. The pick-up, while fairly moderate, was widespread and probably reflected, in large part, the past year's acceleration in hourly compensation and unit labor costs in the domestic economy.

Monetary Policy and Financial Developments during 1988

During 1988, Federal Reserve policy continued to be characterized by a flexible approach to monetary targeting, with System actions responding to emerging conditions in the economy and in financial markets, as well as to growth of the monetary aggregates. This approach has been necessitated by the short-run variability in the relation of these aggregates to economic performance, owing primarily to their sizable response to changing interest rates, in addition to spending.

Implementation of Monetary Policy

During the early months of last year, the Federal Open Market Committee sought to counter any economic weakness that could result from the stock market break and to ensure the smooth functioning of domestic financial markets. In addition, special emphasis was placed on monitoring domestic financial markets for signs of any new distress and on being alert to the need to alter the provision of reserves quickly in response to any trouble.

Growth of Money and Debt (Percentage changes)[2]

		M1	M2	M3	Debt of Domestic Nonfinancial Sectors
Fourth quarter to fourth quarter	1979	7.7	8.2	10.4	12.3
	1980	7.4	9.0	9.6	9.6
	1981	5.2 (2.5)[3]	9.3	12.3	10.0
	1982	8.7	9.1	9.9	9.0
	1983	10.2	12.1	9.8	11.3
	1984	5.3	7.7	10.5	14.2
	1985	12.0 (13.0)[4]	8.9	7.7	13.2
	1986	15.6	9.3	9.1	13.3
	1987	6.4	4.2	5.7	9.8
	1988	4.3	5.3	6.2	8.7
Quarterly growth rates 1988 *(annual rates)*	Q1	3.2	6.2	6.8	8.2
	Q2	6.4	6.9	7.2	8.7
	Q3	5.2	3.8	5.5	8.6
	Q4	2.4	3.8	4.9	8.4

Based on evidence of a greater potential for higher wage and price inflation and in the context of rapid growth in M2 and M3, the Federal Reserve firmed reserve conditions further in a series of steps beginning in March and culminating in early August with a 1/2 percentage point hike in the discount rate. These moves brought about substantial increases in short-term interest rates, but were accompanied by only small increases in Treasury bond yields, as investors viewed Federal Reserve actions as heading off a long-term acceleration of inflation. The upturn in short-term interest rates, coupled with more optimistic expectations of future inflation, helped boost the foreign exchange value of the dollar during this period.

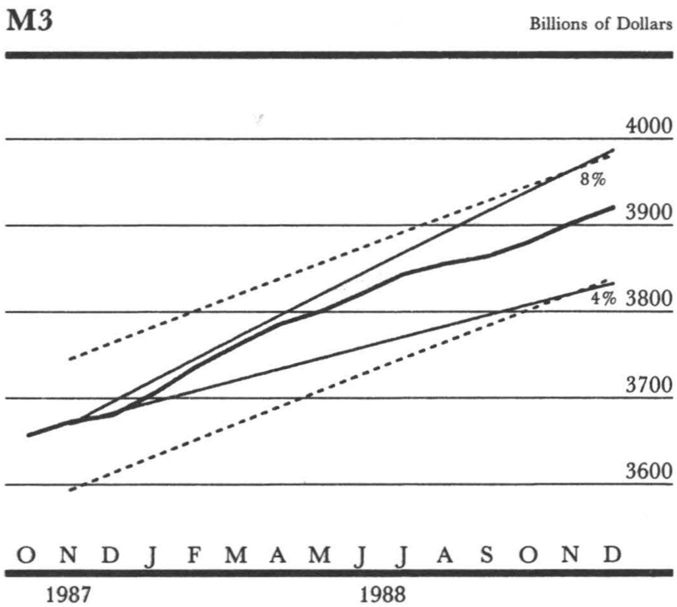
During October and November, the foreign exchange value of the dollar declined, partly in response to a rise in foreign interest rates relative to U.S. market interest rates and to investor concern over the lack of progress in reducing the U.S. federal budget deficit and the slowing improvement in the U.S. trade deficit.

In late fall, incoming data suggested that previous monetary restraint had not been sufficient to relieve the potential for higher inflation and the Committee resumed tightening reserve conditions in a series of moves beginning in November and extending into the new year. As a result of these measures, short-term market interest rates rose. In contrast, bond yields continued to fluctuate narrowly, signalling the market's continued confidence that inflationary pressures would be contained. This confidence together with the firming of policy contributed to a strengthening of the foreign exchange value of the dollar.

Behavior of Money and Credit

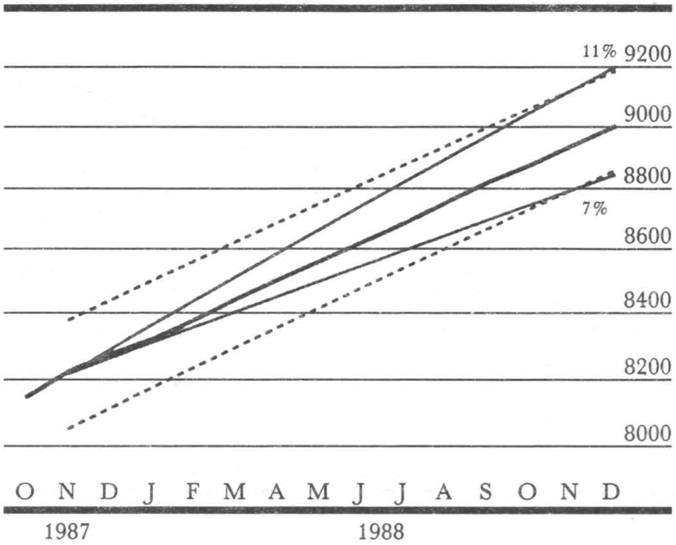
M2 expanded 5.3 percent last year, just below the middle of its 4-to-8 percent target range. Although demands for M2 were supported by strong growth in income and spending, they were reduced by increases in its opportunity cost—that is, the difference between market interest rates and the yields on M2-type instruments.

The composition of the growth of the components of M2 also responded to changes in deposit rates and market interest rates. Yields on liquid deposits—interest-bearing checking deposits, savings deposits, and money market deposit accounts—changed very little over the year.



Debt

Billions of Dollars



M3 grew 6.2 percent last year, placing it slightly above the midpoint of its 4-to-8 percent target range. This increase from a 5.8 percent growth in 1987 reflected a modest pickup in the issuance of managed liabilities in M3 to fund credit expansion at banks and thrift institutions.

The debt of domestic nonfinancial sectors expanded nearly 8¾ percent during 1988, down from 9 percent in 1987, placing it near the midpoint of the Committee's 7-to-11 percent monitoring range. Although debt expansion was well below the pace of the mid-1980s, it still exceeded nominal GNP growth.

Other Financial Developments

Although the economy continued to grow at a strong pace last year and the financial markets recovered from their skittishness following the stock market break of 1987, financial developments in certain markets and sectors warranted the attention of policymakers. Of particular note were the worsening condition of the thrift industry, the need to achieve sounder capitalization of commercial banking organizations, and the rising indebtedness of businesses involved in restructuring activity.

As the year wore on, the dimensions of the problems facing the thrift industry became clearer. Although industry losses eased in the third quarter from their record levels in the first half of 1988, this development appears largely to have reflected FSLIC assistance transactions during the third quarter, rather than a significant underlying improvement in earnings.

Despite the turmoil in the thrift industry, there has been no noticeable disruption of mortgage activity. In part, the development of a deep secondary mortgage market has separated the origination of loans from the need to fund them. For this reason, the base of mortgage credit has been broadened in recent years, making the provision of mortgages far less dependent on the condition of any one type of financial institution or on the regional supply of loanable funds.

In contrast to the thrift industry, preliminary data indicate that U.S. commercial bank profits were reasonably strong in 1988. Moreover, most large money-center banks with a significant amount of loans to developing countries have continued to build capital, which provides a cushion against default losses. Giving added impetus to efforts to raise equity was the agreement by bank supervisory authorities of major industrial countries to set more stringent, risk-based standards of capital adequacy. These standards, to be fully phased in by 1992, place a greater emphasis on equity capital, take into account the off-balance sheet activities of banks, and provide a more uniform regulatory treatment of banks based in different countries.

As in 1987, banks lent considerable sums to finance mergers and leveraged buyouts. Although banks have reported that these loans have had a lower rate of loss than all other business loans combined, and although LBO borrowers typically obtain some insurance against higher loan rates, concern remains about bank exposure to losses in the event of an adverse turn in business conditions. For this reason, the Federal Reserve is closely monitoring developments in this area and has just revised its bank examination guidelines to ensure that member bank loans used to finance buyouts and other highly leveraged corporate restructurings meet prudent credit standards.

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 1989.

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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