

FEDERAL RESERVE SYSTEM. Monetary

POLICY REPORT [1990--SERIES]

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1990 MONETARY POLICY OBJECTIVES

Midyear Review of the Federal Reserve Board

Federal Reserve System. Board of
Governors.

July 18, 1990

1990 MONETARY POLICY OBJECTIVES

This Executive Summary provides highlights of the Board's
Midyear Review to the Congress on
Monetary Policy pursuant to the Full Employment and
Balanced Growth Act of 1978.

July 18, 1990

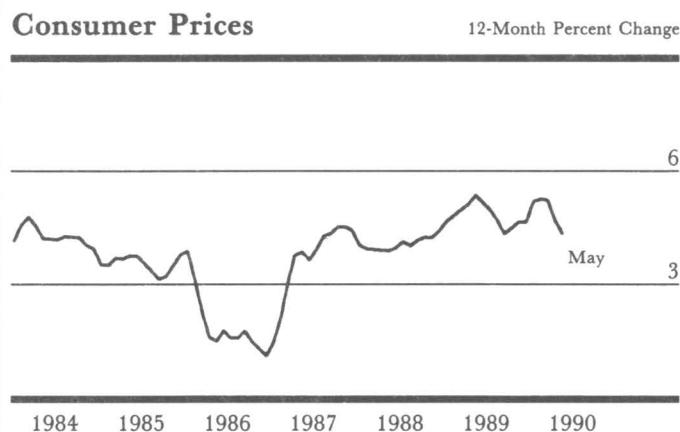
Contents

Section	Page
Monetary Policy and the Economic Outlook for 1990 and 1991	3
Development Thus Far in 1990	3
Monetary Objectives for 1990 and 1991	4
Economic Projections for 1990 and 1991	5
The Performance of the Economy During the First Half of 1990	7
Price Developments	7
The Household Sector	8
The Business Sector	8
The Government Sector	9
The External Sector	10
Labor Markets	10
Monetary and Financial Developments During the First Half of 1990	11
The Implementation of Monetary Policy	12
Monetary and Credit Flows	13

Monetary Policy and the Economic Outlook for 1990 and 1991

The Federal Reserve delivered its initial Humphrey-Hawkins report of 1990 to the Congress in February, and the period since then has been an especially challenging one for monetary policy decisionmaking. The already difficult task of moving a quite fully employed economy toward price stability without mishap has been further complicated by a variety of disturbances to business activity and financial markets.

Inflation has been somewhat greater on average than expected in February; however, this mainly reflected the influence of transitory factors early in the year. Price increases recently have been more moderate. Meanwhile, the economy has continued to expand, but apparently rather sluggishly overall since the winter.



While these aspects of the economic situation were important elements in the Federal Open Market Committee's (FOMC) review of its policy plans earlier this month, the Committee also gave careful attention to developments in financial markets. Although market interest rates had changed little on net since February, slow growth of the monetary stock and other evidence in hand pointed to a small but significant tightening of credit supplies. This implied greater effective restraint on aggregate demand in the months ahead than was thought desirable, and in the past week the System shifted to a slightly more accommodative stance in the provision of reserves to depository institutions. As a result, the overnight federal funds rate, which had

fluctuated narrowly around 8¼ percent throughout the first half of the year, has declined to about 8 percent, and other market rates of interest also have eased a bit in recent days.

Developments Thus Far in 1990

In the early part of 1990, economic activity appeared to be regaining momentum, a development that reduced previous concerns about recessionary risks. At the same time, even discounting weather-related spurts in food and energy prices and an unusual bunching of price increases for some other items, there appeared to be no abatement in underlying inflationary pressures. Through the first quarter, M2 remained near the top of the annual range set by the Committee. Although M3 was near the lower bound of its range, this weakness appeared consistent with the anticipated effects of the restructuring of the thrift industry.

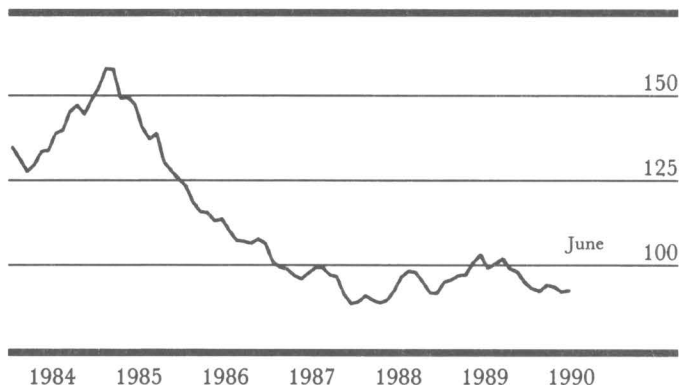
The Federal Reserve maintained a steady pressure on reserve positions during the first quarter, rather than extending the sequence of easing steps that had fostered a drop in the federal funds rate of 1½ percentage points between June and December of 1989. However, in keeping with the tenor of most of the economic data released during the quarter, other interest rates generally moved higher, particularly at the long end of the yield curve. This shift suggested that market participants had re-evaluated the prospects for moderating inflation and a further easing of monetary policy. Early in the year, bond yields in the United States rose along with rates in Japan and Western Europe, as developments in Eastern Europe suggested a further spur to worldwide economic activity, carrying the potential for greater inflation and heightened pressures on a limited international pool of savings.

In the second quarter, some of the weather-related increases in food and energy prices that had caused inflation to pick up earlier in the year were reversed, and price increases for many other goods and services moderated. Inflation trends remained in the range prevailing over the prior three years, though price pressures in the industrial sector gave signs of some easing. The incoming information pointed to a sluggish pace of economic expansion.

In foreign exchange markets, the dollar has depreciated somewhat on balance thus far this year, under the influence of a diverse set of economic, financial and political developments around the world. The dollar has appreciated slightly in terms of the yen, while depreciating somewhat in terms of the German mark and other currencies of the European Monetary System (EMS) exchange rate mechanism and somewhat more in terms of the Swiss franc and pound sterling.

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.

The monetary aggregates flattened out during the second quarter, and by midyear M2 was in the lower half of its annual range and M3 had fallen below the lower bound of its annual range. The weakness in the monetary aggregates mainly, though not wholly, reflected a rechanneling of credit flows away from depository institutions. Total borrowing by domestic nonfinancial sectors moderated only a little in the first half of 1990 from the pace of 1989. Growth in the aggregate debt of these sectors was in the middle of the FOMC's monitoring range. However, the proportion of lending accounted for by depositories was down substantially, much of the decrease related to the shrinkage of savings and loan associations. Meanwhile, concerns about credit quality and pressures on capital positions led banks to adopt more cautious lending postures and to hold down asset growth.

With depository credit damped, not only were managed liabilities weak, but banks and thrifts did not bid aggressively for retail funds—thereby contributing to reduced growth of M2. In addition, increases in expected returns on stocks and bonds may have restrained expansion of this aggregate, although some portion of the slowdown in M2 remains unexplained by changes in relative yields or income. The weakness in depository credit and the monetary aggregates likely has had, to date, only limited effects on spending. The bulk of the credit formerly supplied by depositories has been provided by other lenders, in part through the securities markets, with little change in the terms to most borrowers.

Monetary Objectives for 1990 and 1991

In re-evaluating its ranges for money and credit for 1990 and in establishing tentative ranges for 1991, the FOMC had to take account of the redirection of credit flows away from depository institutions and the resulting effect on the growth of the financial aggregates relative to spending and prices. In February, the Committee expected that the continued shrinkage of the thrift industry would damp growth in M3. To take account of this, it lowered the M3 range for 1990 to 2½ to 6½ percent, one percentage point below the range set tentatively in July 1989. However, the contraction of thrift assets has been faster than anticipated, in part because of the step-up in Resolution Trust Corporation (RTC) activity, and bank credit has expanded less rapidly. As a consequence, through June, M3 grew at an annual rate of only 1¼ percent from its fourth-quarter 1989 base.

Ranges for Growth of Monetary and Credit Aggregates¹

(Percent Change, Fourth Quarter to Fourth Quarter)

	1989	Adopted in February 1990	Adopted in July 1990	Provisional for 1991
M2	3 to 7	3 to 7	3 to 7	2½ to 6½
M3	3½ to 7½	2½ to 6½	1 to 5	1 to 5
Debt	6½ to 10½	5 to 9	5 to 9	4½ to 8½

The weakness in M3 growth is expected to continue into the second half of the year and to be associated with a further substantial increase in velocity—the ratio of nominal GNP to money. Recognizing this unusual behavior of M3 velocity, the FOMC voted in early July to reduce the M3 range for 1990 to 1 to 5 percent. At the same time, the Committee reaffirmed its range of 5 to 9 percent for total growth in the debt of domestic nonfinancial sectors. The Committee seeks to ensure that credit continues to be available in amounts and at terms compatible with further moderate expansion of the economy. It will continue to assess the implications of developments at depositories for credit conditions more generally.

The contraction of the thrift industry and the moderate growth in bank credit also have affected the growth of M2, as potential inflows of retail deposits have outpaced the needs of depository institutions for such funds. The velocity of this aggregate has risen, unexpectedly, but less than that of M3. Growth of M2 from its fourth-quarter base through June was at a 3¾ percent annual rate, within its annual range, though in the lower half. M2 velocity is likely to increase further over the second half of the year; however, a substantial slowing of M2 could suggest more restraint than would be consistent with sustained upward momentum of the economy, and thus the Committee reaffirmed the established range for M2 growth for 1990.

In setting ranges for 1991, the Committee faced more than the usual uncertainty about the growth of money that would foster its objectives of sustained expansion and a gradual abatement of inflation. For M2, the Committee tentatively adopted a range of 2½ to 6½ percent—one-half percentage point below the 1990 range. The adjustment is consistent with the Committee's intention to move over time toward the low trend rates of monetary expansion that would be consistent with price stability. At the same time, the range is expected to allow for sufficient expansion of money to sustain moderate growth in the economy.

The range for growth of M3 was tentatively set at 1 to 5 percent, the same as that now in effect for 1990. The growth of this aggregate is especially sensitive to the pattern of credit flows. Thus, the continuing downsizing of the thrift industry is likely to result in slower growth of M3 than of M2 again next year, as managed liabilities in the broader aggregate run off.

For debt, the FOMC adopted a tentative monitoring range of 4½ to 8½ percent, a half percentage point below the range for 1990. The Committee viewed slower growth of debt, more in line with the expansion of nominal income, as a healthy development for the economy.

Economic Projections for 1990 and 1991

The members of the FOMC and the Reserve Bank presidents not currently serving as members believe that the monetary ranges for 1990 and 1991 are consistent with achievement of sustainable economic growth and a reduction of inflation over time. Most of them expect that the pace of expansion will be moderate over the remainder of 1990 and through the next year. The central tendency of their forecasts of real GNP growth is 1½ to 2 percent over the four quarters of 1990 and 1¾ to 2½ percent over the course of 1991.

Demand from abroad is likely to provide support for continued growth in U.S. production and employment. At current exchange rates, U.S. producers appear to be in a position to compete effectively in most international markets, and economic activity is growing relatively rapidly on average in other major industrial countries. In time, export demand should be bolstered by the shift toward more open, market-based economic systems in Eastern Europe. Although the continental European nations may be most immediately affected by these developments, given the high rates of capacity utilization in those economies, the United States is likely to benefit both directly and indirectly from the increased demand for consumer and capital goods.

The growth of total output projected for 1990 and 1991 probably will involve rather slow gains for the goods-producing sectors of the economy. The service-producing industries are likely to continue to be the locus of important increases in output and, especially, employment. Demands for a wide range of services have remained robust thus far this year, and demographic trends suggest that such sectors as medical care and education will continue to experience appreciable growth.

The overall growth in economic activity forecast for the period ahead is expected to be consistent with a slight easing of pressures on resources and a diminution of inflation. With respect to the labor market, the central tendency of the forecasts for the civilian unemployment rate is 5½ to 5¾ percent in the fourth quarter of this year and 5½ to 6 percent in the final quarter of 1991. The jobless rate has fluctuated narrowly at a little below 5½ percent since late 1988.

Inflation at the retail level also should be damped over the remainder of this year by favorable developments in the energy sector. Despite the very recent upturn in crude oil prices, gasoline prices are widely expected to decline in coming months, as the return of refinery output to normal levels alleviates the tightness that has characterized the product market. With inflation for other goods and services expected to remain below the first-quarter pace, the central tendency of the policymakers' forecasts of the overall Consumer Price Index (CPI) is for an increase of between 4½ and 5 percent over the four quarters of 1990—compared with the 5¾ percent annual rate of increase recorded during the first five months of the year. The lower trajectory of the CPI is projected to be sustained in 1991, with forecasts for the year centering on the 3¾ to 4½ percent range.

Economic Projections for 1990 and 1991

		FOMC Members and other FRB Presidents	Administration
1990		Range	Central Tendency
Percent change, fourth quarter to fourth quarter:	Nominal GNP	5 to 6½	5½ to 6½
	Real GNP	1 to 2	1½ to 2
	Consumer price index	4 to 5	4½ to 5
Average level in the fourth quarter, percent:	Civilian unemployment rate	5½ to 6½	5½ to 5¾
1991		Range	Central Tendency
Percent change, fourth quarter to fourth quarter:	Nominal GNP	3½ to 7	5¼ to 6½
	Real GNP	0 to 3	1¾ to 2½
	Consumer price index	3½ to 5	3¾ to 4½
Average level in the fourth quarter, percent:	Civilian unemployment rate	5¼ to 7	5½ to 6

1. CPI-W. FOMC forecasts are for CPI-U.

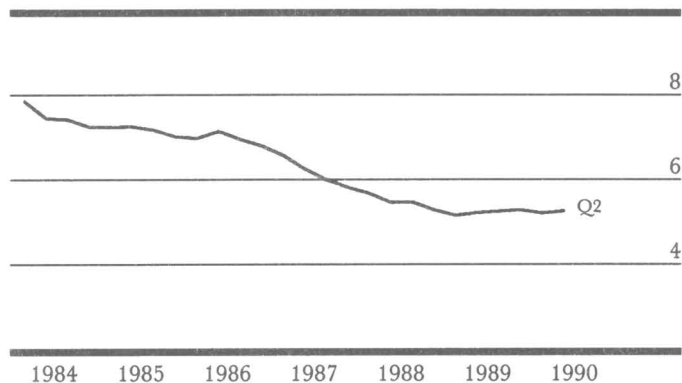
2. Percent of total labor force, including armed forces residing in the United States.

The Performance of the Economy During the First Half of 1990

Production expanded further during the first half of 1990, but evidently no faster than the reduced pace of 1989. The comparatively slow rate of growth largely reflected weaker spending by domestic businesses and households, while merchandise exports apparently remained on a fairly strong growth path. Although job creation in the private sector of the economy has slowed this year, the civilian unemployment rate has remained near $5\frac{1}{4}$ percent, the lowest level in nearly 20 years.

Civilian Unemployment Rate

Quarterly average, percent



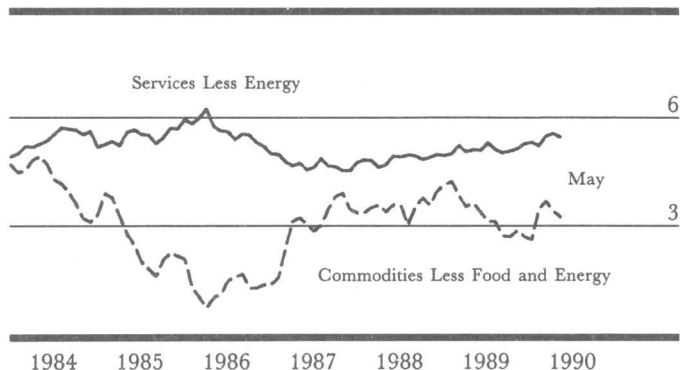
Price Developments

After surging in the first quarter of 1990, price increases moderated this spring. Food and energy prices were boosted early in the year by weather-related developments, and prices for a wide range of other goods and services also picked up sharply. However, by May, the transitory effects of the weather on inflation largely had been reversed, and price increases for many other items slowed significantly.

The CPI excluding food and energy rose about $4\frac{3}{4}$ percent over the twelve months ending in May, near the upper end of the range experienced during the current expansion. Price increases for consumer goods, particularly apparel, rose sharply early in the year. However, the burst in prices did not carry through to the second quarter, as prices for commodities excluding food and energy were little changed in April and May.

Consumer Prices Excluding Food and Energy

12-Month Percent Change



In the service sector, inflation rose markedly in the first quarter, in part reflecting some bunching of increases for items whose prices tend to change in irregular jumps, such as public transportation fares and auto registration fees. Although inflation in service prices moderated in the spring, there was little retracing of the earlier increases. Indeed, in May, the CPI for nonenergy services was $5\frac{1}{2}$ percent above its level twelve months earlier, the upper end of the range of increases seen over the past three and a half years. Increases in prices of rents, medical services, and a variety of labor-intensive services have contributed significantly to the rise in overall service prices so far this year.

The signs of moderating inflation for goods at earlier stages of processing, which had surfaced as capacity utilization rates moved down during 1989, appear to have continued into 1990. After rising $4\frac{1}{4}$ percent in 1989, the Producer Price Index (PPI) for finished goods excluding food and energy has increased at an annual rate of about $3\frac{3}{4}$ percent during the first six months of 1990. Producer prices for intermediate materials excluding food and energy increased at an annual rate of just $\frac{3}{4}$ percent between December and June, roughly the same rate of increase as recorded over 1989 as a whole. The moderation of inflation for goods at the producer level is perhaps one indication that earlier moves toward monetary restraint and the slower pace of

economic activity have worked to ease the resource constraints that had pushed up materials prices between 1987 and early 1989.

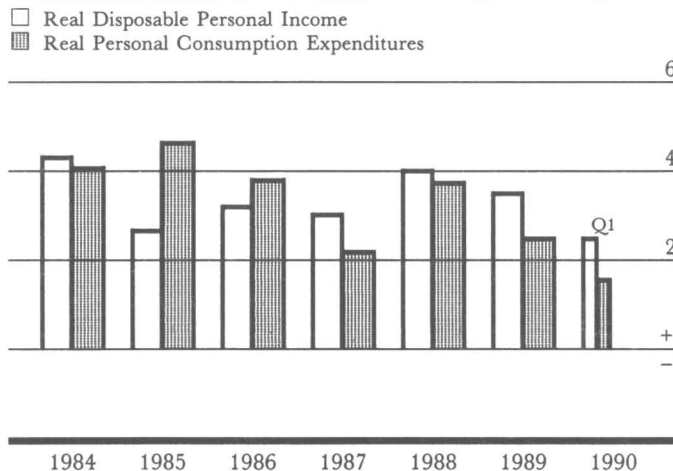
The Household Sector

Total personal consumption expenditures were buffeted this winter by large swings in outlays for energy items and motor vehicles. Expenditures for home heating declined sharply in the first quarter as unseasonably warm temperatures in January and February followed a December that had been colder than usual. This influence was largely offset by a rise in motor vehicle sales. To date this year, sales of cars and light trucks have averaged 14 million units (annual rate)—a pace not far below the total for 1989—and seem largely to reflect replacement demand and growth in the driving age population.

Abstracting from the swings in outlays on home heating and motor vehicles, consumption spending appears to have stagnated this spring after posting a moderate gain in the first quarter of 1990. The recent sluggishness in spending reflects declines in outlays for a wide variety of consumer goods, including furniture and other household durables. In contrast, spending for services other than energy, especially medical services, continues to outpace real income growth.

Real Income and Consumption

Percent change from end of previous period, annual rate



Growth of consumption has slowed this year against a backdrop of somewhat smaller gains in real disposable personal income. But consumption has slowed even more than income, and the personal saving rate rose above 6 percent in the spring. Consumers may be spending more cautiously as they reassess their income and wealth prospects in light of the slower growth of the economy and a softening of residential property values in many parts of the country.

Both demand and supply factors have contributed to the recent weakness in housing construction. Sales of new and existing homes generally have been moving lower for more than a year; in part, demand may have been restrained by slower growth in income and reduced investment motivation for home purchase because of softening house prices. Demand also may have been tempered this spring by some edging up in mortgage rates. Since early May, however, mortgage rates have moved down about 1/2 percentage point, and there is no evidence that access to home loans has been curtailed.

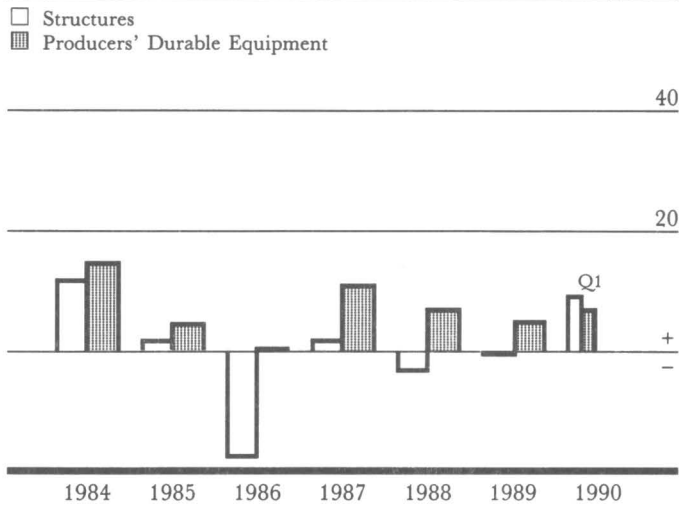
On the supply side, building is being deterred in some parts of the country by an overhang of unsold or unrented housing units. In addition, it appears that a reduction in credit availability for construction may be playing some role in damping building activity. To a degree, this less favorable credit climate is attributable to the cutback in financing supplied by thrift institutions owing to the closure of savings and loans as well as the more stringent capital requirements and lending limits mandated by the Financial Institutions Reform, Recovery, and Enforcement Act.

The Business Sector

The financial position of the business sector deteriorated further during the early part of 1990. Before-tax profits from current operations of nonfinancial corporations edged down in the first quarter after falling nearly 18 percent over the four quarters of 1989.

Real Business Fixed Investment

Percent change from end of
previous period, annual rate



Shrinking profits, which have reduced the availability of internal funds, along with a slower growth of final sales and easing of capacity pressures over the past year, have muted the demand for new plant and equipment. Excluding transitory developments in the transportation sector, real equipment spending slowed further in the first quarter of 1990; while shipments of most types of capital goods—especially industrial machinery—remained soft in April and May.

Nonresidential construction was boosted by favorable weather early in the year, but most of the gain has since been reversed. The weakness is most evident in office and commercial real estate, for which vacancy rates are high and data on contracts and permits suggest the outlook for building remains decidedly negative.

The emergence of uncomfortably high inventories in some sectors in late 1989 led to corrective actions in the first part of this year. Most prominently, manufacturers of motor vehicles cut production sharply and reinstated widespread sales incentives to eliminate an overhang of stocks on dealer lots. In most other sectors, stocks have been trimmed or have been increased only modestly this year, and

they appear to be in good alignment with sales trends. Among the possible exceptions are wholesale distributors of machinery and nonauto retailers, where some mild overhangs appear to have developed this spring; these could precipitate further adjustments, probably affecting both domestic and foreign producers.

The Government Sector

The federal budget deficit over the first eight months of the fiscal year was \$152 billion, up from \$113 billion. About \$15 billion of this increase resulted from spending by the Resolution Trust Corporation and further RTC outlays during June imply that the year-to-year deficit increase is likely to widen. Most of the RTC spending reflects financial transactions in which existing federal insurance obligations to thrift depositors are being recognized in the government's budget outlay and public debt accounts. The RTC's borrowing and spending thus should have little effect on real economic activity or interest rates.

However, several other budget components also have contributed to the higher deficit. While defense outlays have continued to be restrained, spending on Medicare and other health care programs and some discretionary programs has surged. During the same period, revenue growth has lagged as weak corporate profits have cut into receipts and last year's surprisingly large personal income tax collections have not been sustained.

Real state and local government purchases increased at an annual rate of 4¼ percent in the first quarter, compared with the 3 to 3½ percent pace recorded over the past three years. Revenue growth generally has not kept up with gains in spending, however, and an increasing number of state and local governments face significant budgetary difficulties; indeed, the overall deficit of the sector (excluding social insurance funds) was about \$45 billion (annual rate) in the first quarter of 1990, almost \$11 billion greater than the deficit recorded in the 1989 calendar year.

The External Sector

While the value of the dollar has not changed dramatically on a trade-weighted average basis against the other G-10 currencies this year, there have been some divergences in bilateral exchange rates. On balance, the dollar has depreciated significantly against sterling and the Swiss franc, and somewhat less against the German mark and related currencies. In contrast, the dollar has appreciated against the yen, despite exchange market intervention by the Bank of Japan and other central banks to support the value of the yen early in the year.

Prices of non-oil imports, which fell at about a 3 percent annual rate between the first and third quarters of last year, rose at a similar pace between the third quarter of 1989 and first quarter of 1990. Prices of imported oil surged around the turn of the year, moving above \$20 per barrel in January, but since then they have more than retraced this runup.



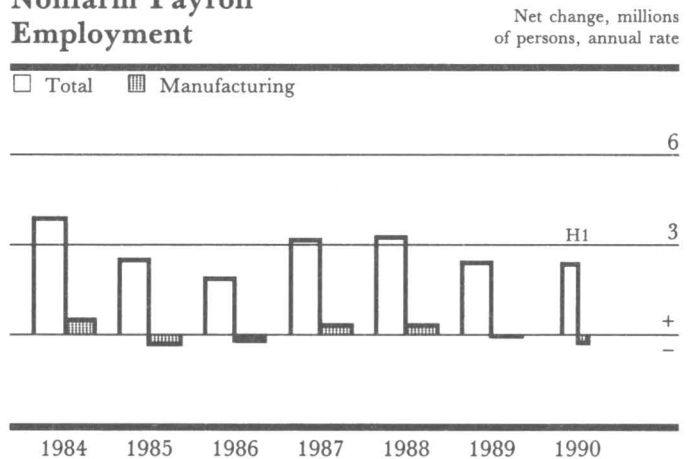
Merchandise exports continue to provide an important impetus to growth in the domestic economy, although the increases in exports have slowed somewhat from the very rapid advances recorded in the latter part of the 1980s. Two factors have contributed to further large gains in the quantity of U.S. exports: many of our major trading partners abroad have continued to register strong economic growth, and the average dollar prices of U.S. exports have declined somewhat relative to average prices abroad. Meanwhile, slower import growth has accompanied the slackening pace of activity in the United States.

Labor Markets

Job growth was strong early in the year, but has softened recently. In January and February, increases in nonfarm payroll employment averaged more than 350,000, fueled by large increases in service-producing industries as well as by robust hiring in construction during the warmer than normal winter weather. Since March, however, job growth has slowed, averaging about 125,000 jobs per month. Manufacturing employment has continued to shrink this year at about the same rate as in the second half of 1989, and construction payrolls also have declined since the winter. Meanwhile, job growth in the service-producing industries has slowed in recent months. Although hiring gains have continued strong for health services, growth in jobs in business services has moderated, and there have been only small gains in employment at retail establishments.

Although the rate of increase in straight-time wages has changed little over the past year and a half, benefit costs have picked up markedly. In addition, unit labor costs have been boosted by a poor performance in labor productivity. As a consequence, unit labor costs in the first quarter of 1990 were 5 percent above their level a year earlier, about the same increase as recorded over 1989 as a whole, but well above the rates that prevailed earlier in the expansion.

Nonfarm Payroll Employment



Monetary and Financial Developments During the First Half of 1990

Shifts in financial intermediation and credit flows, stemming from the continued restructuring of the thrift industry and a more cautious attitude of banks toward certain credit extensions, exerted a major influence on the monetary aggregates and their relation to economic activity during the first half of 1990. In anticipation of further contraction in the thrift industry, and its associated effects on depository intermediation, the Committee reduced the annual growth range for M3 by a full percentage point in February. In the event, M3 has slowed even more dramatically than had been anticipated, leaving this aggregate below the lower bound of its

reduced range. Not only has the thrift industry contracted more rapidly than expected, but commercial banks have picked up little of the lending forgone by thrifts and, in fact, have curtailed their own lending in some sectors, thus further depressing depository credit. With little need to fund asset growth, banks and thrifts have pursued retail deposits less aggressively, leading to the opening of a sizable gap between yields available in the open market and those on such deposits. Partly as a result, M2 also has slowed, moving down into the lower portion of its annual growth range.

Growth of Money and Debt (Percentage change)

		M1	M2	M3	Debt of Domestic Nonfinancial Sectors
Fourth quarter to fourth quarter	1980	7.4	8.9	9.5	9.5
	1981	5.4 (2.5)*	9.3	12.3	10.2
	1982	8.8	9.1	9.9	9.1
	1983	10.4	12.2	9.8	11.2
	1984	5.4	7.9	10.6	14.2
	1985	12.0	8.9	7.8	13.1
	1986	15.5	9.3	9.1	13.2
	1987	6.3	4.3	5.8	9.9
	1988	4.3	5.2	6.3	9.1
	1989	0.6	4.5	3.3	8.1
Quarterly 1990 (annual rate)	Q1	4.8	6.0	2.7	6.9
	Q2	3.6	2.3	0.4	7.0 ^e
Semiannually 1990 (annual rate)	H1	4.2	4.2	1.6	7.0

*Figure in parentheses is adjusted for shifts to NOW accounts in 1981.

e—estimated

The deceleration of the monetary aggregates mainly reflects a reduction in the share of credit provided by depositories, rather than a sharp slowing of income or total credit flows. The velocities of both M2 and M3 posted sizable increases, particularly in the second quarter. Total debt of nonfinancial sectors grew at an annual rate of 7 percent over the first half of the year—down only slightly from its pace in the latter half of 1989 and in the middle of its monitoring range.

The somewhat more cautious lending posture that commercial banks have recently adopted is mainly a response to heightened credit risks caused by the more moderate pace of economic expansion overall and a downturn in several sectors. The resulting loan write-offs and pressures on capital positions may also have induced some tightening of standards. Growing markets for securitized loans largely have filled the vacuum created by the retrenchment of thrifts in the area of mortgage lending, with little attendant effect on the cost or availability of residential mortgage credit to households. Both banks and thrifts have cut back on other types of lending that can less easily be rechannelled, however, including construction and nonresidential real estate loans, loans to highly leveraged borrowers, and loans to small and medium-sized businesses. To offset tighter credit market conditions, which could exert undue restraint on aggregate demand, the Federal Reserve has recently adopted a slightly more accommodative stance with regard to reserve provision, fostering a small decline in market interest rates.

The Implementation of Monetary Policy

The FOMC maintained a steady degree of pressure in reserve markets during the first six months of the year. Policy had been eased in the second half of 1989 amid concerns that the economic slowdown might cumulate and thereby threaten the expansion. In the first half of 1990, however, the Committee viewed the balance of evidence as suggesting that underlying trends were generally consistent with its objectives of sustaining economic growth while containing and eventually reducing inflationary pressures.

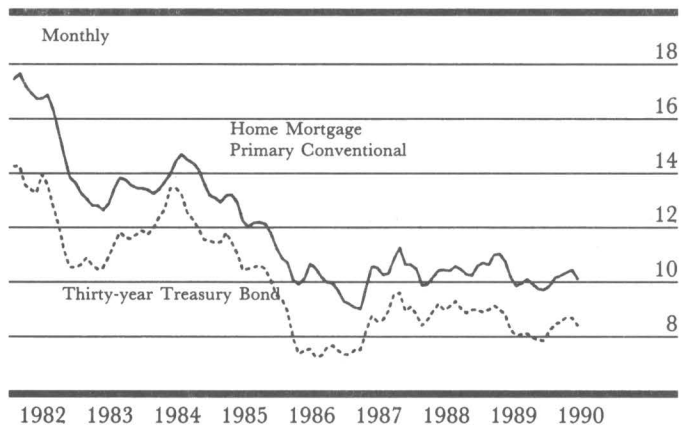
In the opening months of the year, incoming information on spending and prices caused markets to re-evaluate the prospects for a near-term reduction of inflationary pressures and further easing of monetary policy. As a result, market interest rates rose, particularly at the longer end of the maturity spectrum, despite a steady federal funds rate.

In early May, the pendulum of market opinion began to swing away from the view that a tightening of U.S. monetary policy was in the offing as incoming data pointed to a somewhat slower pace of activity and reduced price pressures. Evidence also suggested that restricted credit availability, in part the result of tightened credit standards, may have spread beyond commercial real estate, construction, and merger related lending. In response to this firming of credit conditions, the Federal Reserve began providing reserves slightly more generously through open market operations in mid-July.

Market interest rates, which already had receded somewhat from their early spring highs, declined further with the Federal Reserve's recent easing, though intermediate and long-term rates remained above the levels seen last December.

Long-term Interest Rates

Percent



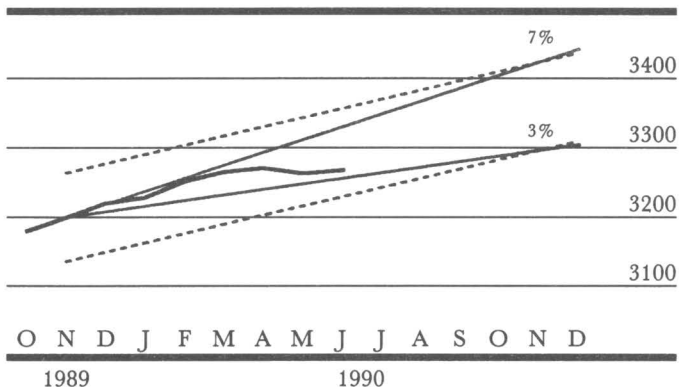
Observations are monthly averages of daily data;
last observation for June, 1990.

Monetary and Credit Flows

Growth of the monetary aggregates was sluggish over the first half of 1990, with M2 and M3 expanding at annual rates of only 3½ percent and 1¼ percent, respectively, from the fourth quarter of 1989 through June. The weakness in money growth primarily reflected a redirection of credit extensions away from depository institutions owing to the continued downsizing of the thrift industry and a more cautious lending posture of commercial banks.

M2

Billions of Dollars

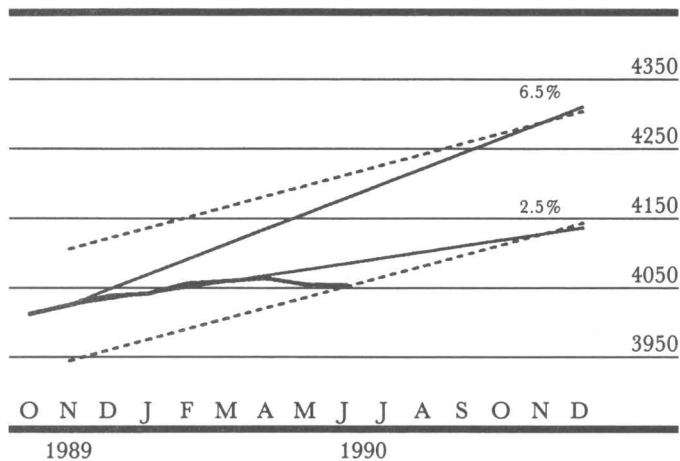


The deceleration of M2 growth did not begin until the second quarter of 1990, when growth slowed to a 2¼ percent annual rate from the 6 to 7 percent range seen in the previous three quarters. Retail deposits (which include NOW accounts as well as savings, small time deposits, and similar instruments) had begun to decelerate in the first quarter, slowing to a pace of less than 4 percent from the 5¾ percent rate seen in the fourth quarter of 1989.

The unwillingness of banks to price their deposits as aggressively as in the past is partly an indirect result of the contraction of the thrift industry. During the first six months of 1990, commercial banks enjoyed \$62 billion in retail deposit inflows—about a 10 percent increase at an annual rate—while thrifts were shedding \$28 billion in retail deposits—about a

M3

Billions of Dollars



5 percent annual rate of contraction. Much of this deflection of deposits towards commercial banks was the direct result of RTC resolutions. In the first half of the year, the RTC resolved 170 thrifts holding \$32 billion of nonbrokered retail deposits, with much of these deposits immediately assumed by commercial banks.

Bank lending to businesses also has been depressed this year. Surveys of commercial bank lending officers through early May suggest that the slowdown in bank credit largely reflects diminished demand for credit and deteriorating conditions in the real estate market, although tighter lending terms and more stringent credit standards were frequently cited for borrowers below investment grade, including many small businesses. Banks seem to have raised lending rates somewhat to small firms, judging from the slight increase in the spread between rates on small business loans and on federal funds. Separate surveys in which small businesses were queried about general credit availability have pointed to some recent increases in the difficulty these firms face in obtaining credit, though on balance they found credit availability little changed from mid-1989. The slowdown in bank business lending this year has mainly reflected reduced merger activity.

Footnotes

1. **M1** is currency held by the public, plus travelers' checks, plus demand deposits, plus other checkable deposits [including negotiable order of withdrawal (NOW and Super NOW) accounts, automatic transfer service (ATS) accounts, and credit union share draft accounts].

M2 is M1 plus savings and small denomination time deposits, plus Money Market Deposit Accounts, plus shares in money market mutual funds (other than those restricted to institutional investors), plus overnight repurchase agreements and certain overnight Eurodollar deposits.

M3 is M2 plus large time deposits, plus large denomination term repurchase agreements, plus shares in money market mutual funds restricted to institutional investors and certain term Eurodollar deposits.

A copy of the full report to Congress is available from
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