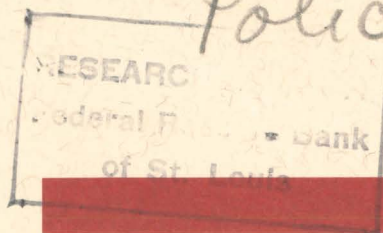


*Federal Reserve System Monetary
Policy Report [1992]*



July 21, 1992

1992 MONETARY POLICY OBJECTIVES

Midyear Review of the Federal Reserve Board

July 21, 1992

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

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Testimony of Alan Greenspan

Chairman, Federal Reserve Board

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to present the Board's semiannual report on monetary policy to the Congress. Earlier this month, when the Federal Open Market Committee formulated its plans and objectives for the next year and a half, it did so against the backdrop of an economy still working its way through serious structural imbalances that have inhibited the pace of economic expansion. In light of the resulting sluggishness in the economy and of persistent weakness in credit and money, the System on July 2 cut the discount rate by $\frac{1}{2}$ percentage point, and eased reserve market conditions commensurately. These actions followed a reduction in the federal funds rate in early April. The recent

easings of reserve conditions should help to shore up the economy, and coming in the context of a solid trend toward lower inflation, have contributed to laying a foundation for a sustained expansion of the U.S. economy.

The U.S. Economy and Monetary Policy

Our recent policy moves were just the latest in a series of twenty-three separate easing steps, beginning more than three years ago. In total, short-term market interest rates have been reduced by two-thirds. The federal funds rate, for example, has declined from almost 10 percent in mid-1989 to $3\frac{1}{4}$ percent currently. The discount rate has been cut to 3 percent—a twenty-nine year low. Despite the cumulative size of these steps, the economic recovery to date nonetheless has been very hesitant. Based on experience over the past three or four decades, most forecasters would have predicted that a reduction of the magnitude seen in short-term interest rates, nominal and real, during the past three years would by now have been associated with a far more robust economic expansion.

Clearly the structural imbalances in the economy have proven more severe and more enduring than many had previously thought. The economy still is recuperating from past excesses involving a generalized overreliance on debt to finance asset accumulation. Many of these activities were based largely on inflated expectations of future asset prices and income growth. In short, an overbuilding and overbuying of certain capital and consumer goods was made possible by overleverage. And, when realities inevitably fell short of expectations, businesses and individuals left with debt-burdened balance sheets diverted cash flows to debt repayment at the expense of spending, while lenders turned considerably more cautious.

This phenomenon is not unique to the United States. To a greater or lesser extent, similar adjustments have gripped Japan, Canada, Australia, the United Kingdom, and a number of northern European countries. For the first time in a half century or more, several industrial countries have been confronted at roughly the same time with asset-price deflation and the inevitable consequences. Despite widespread problems, we seem to have at least avoided the crises that historically have been associated with such periods in the past.

In the United States especially, important economic dynamics ensued as the speculative acquisition of physical assets financed by debt outpaced fundamental demands.

In some markets for physical assets, such as office buildings, a severe oversupply emerged, and prices plummeted. In others, such as residential housing, average price appreciation unexpectedly came to a virtual standstill, and prices fell substantially in some regions. Firms that had been subject to leveraged buyouts based on overly optimistic assumptions about the future values at which assets could be sold began to encounter debt servicing problems.

More generally, disappointing earnings and downward adjustment in the values of assets brought about reduced net worth positions and worsened debt-repayment burdens. Creditors naturally pulled back from making risky loans and investments, and as pressures mounted on lenders' earnings and capital, some features of a "credit crunch" appeared. With borrowers themselves becoming more cautious about taking on more debt, as well as about spending, credit flows to nonfederal sectors diminished appreciably.

It is not that this process was unforeseeable in the latter years of the 1980s. The sharp increase in debt and the unprecedented liquidation of corporate equity clearly were unsustainable and would eventually require a period of adjustment. What was unclear was the point at which financial problems would begin to constrain spending and how strong those constraints would be.

Forecasts of difficulties with debt and strained balance sheets had surfaced from time to time over the past decade. But only in recent years did it become apparent that debt leverage had reached its limits, inducing consumers and businesses to retrench. Moreover, the degree of retrenchment has turned out to be much greater than experience since World War II would have suggested.

The successive monetary easings have served to counter these contractionary forces, fending off the classic "bust" phase that seemed invariably to follow speculative booms in pre-World War II economic history. During those severe episodes, sharp declines in output and income were associated with a freezing up of credit availability, widespread bankruptcies by borrowers, and closings of newly insolvent financial institutions. Thus, balance sheets were cleansed only through the massive writing off of loans, involving a widespread destruction of creditor capital.

To be sure, elements of this historical process have been at work in recent years, but the monetary policy stimulus since mid-1989 has forestalled such a severe breakdown. Lower interest rates have lessened repayment burdens through the refinancing and repricing of outstanding debt, and together with higher stock prices have facilitated the restructuring of balance sheets.

Indeed, considerable progress in this regard has become evident for both households and businesses. The much more subdued rate of household and business credit expansion has reduced the leverage of both sectors. Household debt service payments as a percent of disposable personal income have retraced around one-half of the runup that occurred during the previous expansion, and further progress appears in train. Similarly, nonfinancial corporations' gross interest payments as a percent of cash flow are estimated to have retraced much of the roughly 10 percentage point increase that occurred in the expansion. The improvements in balance sheets, together with the beneficial effects of lower interest rates, have been reflected in reduced delinquencies on consumer loans and home mortgages, increased upgradings of firms' debt ratings, and narrowed quality spreads on corporate securities. Furthermore, lower interest rates, along with two reductions in reserve requirements, have appreciably cut the funding costs of depository lenders, materially improved interest margins, and fostered the replenishment of depository institution capital.

Although greatly moderating the potential adverse effects of the necessary adjustment process on economic activity, monetary stimulus also has stretched out the period over which adjustments will occur.

A more drawn out adjustment of impaired balance sheets, as we now are experiencing, obviously is much preferable to the alternative: an adjustment through massive financial and economic contraction. Yet the ongoing corrective process has meant that the economic expansion has been hobbled in part by the continued restraint on spending by still over-leveraged and hence cautious debtors. Balance sheets ultimately will reach comfortable configurations, but even before then we should experience a quickening pace of economic activity as the grip of debt burden pressures begins to relax. Last year I characterized this process as the economy struggling against a 50-mile-an-hour headwind. Today its speed is decidedly less, but still appreciable.

Uncertainty about how far the process of balance-sheet adjustment would have to go and for how long the spending retrenchment of over-leveraged debtors would continue has been a factor in shaping Federal Reserve policy over the past few years. This uncertainty has been shared by many other observers, who, based on past experience, were somewhat skeptical about the strength and persistence of spending restraint by both the private and public sectors, and dubious about the persistence of disinflationary forces.

Against that background, more rapid or forceful easing actions more than likely would have been interpreted by market participants as risking a resurgence of inflation. That would have led to higher rather than lower long-term interest rates. As I have indicated many times before this Committee, lower long-term rates are crucial in promoting progress toward more stable balance sheet structures in support of sustained economic expansion.

In fact, long-term interest rates have stayed disturbingly high in the face of sharply lower short-term rates. A greater decline in long rates would have encouraged additional restructuring of business and household balance sheets and fostered stronger spending on business fixed investment goods, housing, and consumer durables. Bond yields have not come down more primarily because investors have been inordinately worried about future inflation risks. While they seem to exhibit only modest concern over a reemergence of stronger inflation during the next few years, investors apparently fear a resurgence further in the future, to a large extent as a consequence of expected outsized budget deficits exerting pressure for monetary accommodation.

Other forces have added to the restraint on the economy associated with balance sheet adjustments. The scaling back of defense spending has been retarding near-term economic growth. A significant reallocation of resources is an inevitable consequence of the phase-down of defense spending, involving the redeployment of military personnel as well as industrial and technological capacity into civilian activities. Such shifting of resources away from military production promises a welcome boost to long-run prospects for the nation's productivity and growth. Nonetheless, the process of transition involves significant frictions and lags, and in the meantime the falloff of the military budget has represented a drag on aggregate demand. At the same time, budgetary problems among states and localities have forced painful cutbacks by those units and burdensome tax increases as well.

In addition, the noticeable slowdown in economic growth in other major industrial countries since mid-1990 has further tended to depress demand for goods and services produced in the United States. Fortunately, continued rapid economic growth on the part of developing countries, whose imports from the United States have grown in relative importance, has prevented a greater weakening in the expansion of our exports.

The U.S. Economic Outlook

Clearly in this environment, with conflicting forces of expansion and contraction continuing to vie for supremacy, any projection must be viewed as tenuous. In this context, the central tendencies of the projections of Federal Reserve Board members and Reserve Bank presidents are given in the Board's report. They project that the economic expansion is likely to strengthen moderately, to a range of $2\frac{3}{4}$ to 3 percent over 1993. Such a pace is expected to reduce the unemployment rate noticeably over the next year and a half. This outlook is supported by several considerations, including the stimulus now in train from recent interest rate declines and the progress being made by borrowers and lenders in repairing strained balance sheets. Some pent-up demand for business capital goods, housing, and consumer durables should surface as the incentives for spending retrenchment abate.

In our judgment, the interest rate declines to date, working to offset spending constraints related to balance-sheet strains, should not endanger the further ebbing of inflationary pressures. Even as the anticipated strengthening of economic activity occurs, monetary policy will continue to promote ongoing progress toward the longer-run objective of price stability, which should lay the foundation for sustained economic expansion.

The financial fundamentals, such as money and credit growth, point to a continuation of disinflationary trends, and the central tendency of our projections for CPI inflation next year is $2\frac{3}{4}$ to $3\frac{1}{4}$ percent. Were this to be realized, inflation would be about back to a pace last seen on a sustained basis around a quarter century ago. As I often have noted to this Committee, the most important contribution the Federal Reserve can make to encouraging the highest sustainable growth the U.S. economy can deliver over time is to provide a backdrop of reasonably stable prices on average for business and household decision-making.

Recent Behavior of the Monetary Aggregates

The relationship between money and spending also has been profoundly affected by the process of balance sheet restructuring. The broad monetary aggregates, M2 and M3, currently stand below their annual growth ranges, despite the earlier substantial declines in short-term interest rates. My previous testimonies to the Congress noted that aberrant monetary behavior emerged in 1990 and has since intensified. We at the Federal Reserve have expended a great deal of effort in studying this phenomenon, and have made some progress in understanding it. To summarize our findings to date:

The weakness of the broad monetary aggregates appears importantly to have reflected the variety of pressures that rechannelled credit flows away from depository institutions, lessening their need to issue monetary liabilities. The public, in the process of restructuring and deleveraging balance sheets, found that monetary assets had become less attractive relative to certain nonmonetary financial assets or to debt repayment.

The reduced depository intermediation stemmed from emerging problems of asset quality, which in turn prompted both the pulling back of depositories from lending and responses by regulators that reinforced those tendencies. One such response was the shutting down or sale of insolvent thrift institutions. In the process, some \$90 billion of thrift assets have been taken onto the books of the Resolution Trust Corporation, where they are funded by government securities instead of depository liabilities. The managed liabilities of depositories have been most affected by this shift. However, retail depositors also have been induced to shift into other instruments by the abrogation of their original contracts by acquiring institutions and the consequent disruption of their banking relationships.

At banks and solvent thrifts as well, problems of asset quality, especially for commercial real estate, were mounting as the 1980s came to a close. Banks reacted by tightening their nonprice lending terms and credit standards appreciably and widening the spread of lending rates relative to costs of funds. Upward pressure on bank loan rates was augmented as investors, concerned about adequate bank capitalization, raised risk premiums on bank debt and short-term managed liabilities. In addition, regulatory initiatives, such as stricter capital standards, higher insurance premiums, and more intense supervisory scrutiny, raised the cost of depository intermediation. Reserve requirement cuts have represented only a partial offset. As intermediation costs rose, banks further increased loan spreads and redoubled efforts to securitize loans and otherwise constrain expansion in their balance sheets.

More recently, the decline in short-term market rates, combined with the improvement in asset quality that was partly associated with the modest economic expansion, has considerably boosted bank earnings. Banks also have strengthened their financial condition by improving their liquidity position and by taking steps that should reduce noninterest expenses over the long run through restructuring and, in some cases, consolidation. A number of banks—

especially large banks—have conserved capital by reducing dividends. Banks have regained access to capital markets and have significantly rebuilt their capital positions. Intermediation costs and pressures to bolster capital, however, have been further elevated by the added restrictions contained in the FDIC Improvement Act. Partly as a consequence, lending spreads have stayed relatively high, as suggested by a prime rate that is a substantial $2\frac{3}{4}$ percentage points above the federal funds rate. Recent survey responses suggest that nonprice terms and lending standards, though not tightening further, also have remained stringent.

Bank lending has shown few signs of strengthening, as demands for bank loans have stayed dormant. The internal cash flows of nonfinancial businesses have strengthened, and many firms have raised substantial funds in equity markets, so overall credit demands have been light. Large firms, especially those with good credit ratings, have preferred bond markets over banks as a place to borrow. Meanwhile, households, feeling the strain of debt service burdens, have rechannelled cash flows away from retail deposits to the repayment of consumer debt at banks and other lenders.

They were also encouraged to deleverage their balance sheets by the wider spread between consumer loan rates and retail deposit rates, which was accentuated on an after-tax basis by the phase-out of the tax-deductibility of interest payments on consumer loans.

With little need for new funding, banks and thrifts have lowered rates on retail time deposits, especially on intermediate- and long-term accounts, by more than market rates have declined. Under regulatory pressure, banks also have cut back reliance on, and returns to, brokered deposits. Even on NOW accounts, savings deposits, and money market deposit accounts, where inflows have strengthened, returns on the larger accounts—likely involving the most interest-sensitive depositors—have dropped much faster than have the most common rates paid. The comparatively high returns on longer-term debt and equity instruments also have drawn household assets out of retail deposits. Bond and stock mutual funds in particular have recorded substantial inflows.

Thus, the weakness in the broader monetary aggregates, which has been even more pronounced this year,

can be seen as an aspect of the entire process of rechannelling credit flows away from depositories and of restructuring the public's balance sheets. However, the disintermediation and restructuring forces, which have acted powerfully to depress the growth of money, have exerted a less powerful constraint on spending; that is, slower money growth has not tended to show through percentage point for percentage point to reduced nominal GDP expansion. Accordingly, these disintermediation and restructuring forces have tended to boost the velocity of the broader aggregates. Increasing M3 velocity has been evident for some years, but the tendency for M2 velocity to rise was obscured until recent quarters by the opposing influence of declines in short-term market rates. Lower short rates reduced the potential returns given up by holding liquid M2 balances, thereby providing support to demands for M2 and countering the emerging tendency for its velocity to increase. But M2 velocity appears to have registered an appreciable increase in the first half of this year, and the Federal Reserve has had to take the emerging behavior of velocity into account in deciding how much weight to place on slow M2 growth in guiding its policy actions.

Prospective Behavior of the Monetary Aggregates

Looking ahead, the recent increases in M2 velocity may well continue, although the uncertainties in this regard are considerable. Returns on short-term market instruments relative to rates on M2 balances have dropped to unprecedented lows. Depositories may well reduce liquid deposit rates further to restore longer-run relationships with money-market rates. Should this occur, the resulting shifts in assets would reduce M2 demand without much influencing spending, further boosting the velocity of this aggregate. The velocity of M2 also would tend to increase if any pickup in credit availability at banks associated with stronger economic expansion were funded out of their sizable holdings of liquid securities and newly issued managed liabilities rather than through recourse to retail deposits.

Another significant imponderable involves the public's demand for M2 balances. The extent to which households will continue to repay or avoid debt by drawing down M2 balances is difficult to foresee with any precision, as one cannot accurately gauge households' desired leverage positions. An early completion of household balance-sheet adjustments would help to restore incentives to build liquid money balances, cutting into increases in M2 velocity.

Any decline in long-term market rates could dissuade households from reaching for better returns out the yield curve beyond M2 maturities, and thereby bolster M2 demands even more than it would spending. This would further offset the tendency for disintermediation and deleveraging to raise M2 velocity. All told, predicting either the share of depository intermediation in overall credit flows or the share of money in the public's overall demand for financial assets is currently more difficult than usual.

Against this background of considerable uncertainty about evolving monetary relationships, the Committee retained the current ranges for money and credit growth this year. These growth ranges are $2\frac{1}{2}$ to $6\frac{1}{2}$ percent for M2, 1 to 5 percent for M3, and $4\frac{1}{2}$ to $8\frac{1}{2}$ percent for debt. On a provisional basis, the same ranges also were carried over to next year.

If velocities were to show little further increase, then growth of the monetary aggregates within these specified ranges for both years would be consistent with the achievement of noninflationary economic expansion. The reduction in short-term interest rates resulting from our recent policy action enhances the odds on money growing within these ranges. On the other hand, if the unusual velocity increases seen so far this year were to persist over the next six quarters, then growth of M2 and M3 around or even below the lower bounds of their ranges could still be acceptable.

In any case, the current ranges represent a way station on the road to reasonable price stability. Even with a return to the traditional secular stability of M2 velocity, the midpoint of the current ranges would still be higher than needed to support long-run economic growth in the context of price stability. And, if velocity increases do in fact occur during a transition period to a higher long-run equilibrium level, then ranges somewhat lower than the current specifications would be warranted over this interval. But in light of the considerable uncertainties about nearer-term velocity developments, the Federal Open Market Committee did not commit itself to new, respecified ranges for M2 or M3 for 1992. Such a respecification would carry the presumption that the new range was clearly more consistent with broader economic objectives, and in view of the uncertain relationships involved, the FOMC did not wish to convey that impression. This year's ranges were carried forward on a provisional basis for 1993, until such time as additional experience and analysis could be brought to bear on the issue of monetary behavior. In any event, the FOMC will revisit the issue of its money and credit ranges for 1993 no later than its meeting next February. By then more evidence will have accumulated about evolving monetary relationships.

In light of the difficulties predicting velocity, signals conveyed by monetary data will have to continue to be interpreted together with other sources of information about economic developments.

Concluding Remarks

I expect that the economic expansion will soon gain momentum, which lower inflation should help to maintain. Although the economy still is working its way through structural impediments to more vigorous activity, the advances that already have been made in this regard augur well for the future. Banks and other lenders, having made considerable strides in rebuilding capital, have greater capacity to meet enlarged credit demands. The strengthening of household finances to date has established a firmer foundation for future consumer outlays. And the restructuring of business balance sheets so far, together with improved labor productivity and profitability, has better positioned producers to support sustainable output gains. These gains would be even larger if the federal government can make significant progress toward bringing the budget into balance, releasing saving for productive private investment, and brightening further the prospects for ongoing advances in living standards for all Americans.

Monetary Policy and the Economic Outlook for 1992 and 1993

Monetary Objectives for 1992 and 1993

In reviewing the annual ranges for the monetary aggregates in 1992, the Committee noted the substantial uncertainties created by the unusual behavior of M2 and M3 velocity thus far this year. If portfolio shifts ebb and more normal relationships of depository credit to spending begin to emerge, growth of the monetary aggregates within the existing ranges would be consistent with the Committee's objectives for making progress toward price stability and fostering economic growth. However, it is unclear whether the forces giving rise to the unusual behavior of the aggregates will wane in coming months or continue unabated. Faced with these uncertainties, the Committee chose to retain the 2½ to 6½ percent range for M2 and the 1 to 5 percent range for M3 announced earlier this year for 1992.

Ranges of Growth of Monetary and Credit Aggregates

(Percentage change, fourth quarter to fourth quarter)

	1991	1992	Provisional for 1993
M2	2½ to 6½	2½ to 6½	2½ to 6½
M3	1 to 5	1 to 5	1 to 5
Debt	4½ to 8½	4½ to 8½	4½ to 8½

The Committee also reaffirmed the existing 1992 monitoring range for the aggregate debt of domestic nonfinancial sectors. The more cautious attitudes toward borrowing that have damped credit growth this year, and the improving balance sheets of borrowers, should lay the groundwork for sustained economic expansion in years to come.

The ongoing structural changes in the financial system and the tentative nature of the recovery greatly complicated the task of choosing ranges for the coming year. The Committee recognized that the range for M2 probably would need to be reduced at some point to be consistent with the Federal Reserve's long-run objective of reasonable price stability. However, pending further analysis of the recent relationship of money stock movements to income and interest rates, the Committee chose to carry forward the 1992 ranges for the monetary aggregates and debt as provisional ranges for 1993.

Economic Projections for 1992 and 1993

The members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the discussions of the Federal Open Market Committee, generally believe that the most likely scenario for the economy in the second half of 1992 is one in which real GDP increases at a

moderate pace and job growth is sufficient to impart a downward tilt to the unemployment rate. In 1993, output growth is expected to pick up slightly further from the 1992 pace, bringing additional small reductions in the unemployment rate. Inflation likely will hold to a gradual downward trend over the next year and a half.

Economic Projections for 1992 and 1993

Measure		FOMC Members and other FRB Presidents	
1992		Range	Central Tendency
Percentage change, fourth quarter to fourth quarter:	Nominal GDP	5 to 6¼	5¼ to 6
	Real GDP	2 to 3¼	2¼ to 2¾
	Consumer Price Index	3 to 3½	3 to 3½
Average level in the fourth quarter, percent:	Civilian unemployment rate	7 to 7½	7¼ to 7½
1993		Range	Central Tendency
Percentage change, fourth quarter to fourth quarter:	Nominal GDP	4½ to 7	5½ to 6¼
	Real GDP	2½ to 3½	2¾ to 3
	Consumer Price Index	2½ to 4	2¾ to 3¼
Average level in the fourth quarter, percent:	Civilian unemployment rate	6½ to 7¼	6½ to 7

In quantifying their views of the prospects for economic growth, the Board members and Reserve Bank presidents ended up with forecasts that are somewhat stronger than in February. A large majority of them see the most likely outcome for this year as being one in which real gross domestic product rises $2\frac{1}{4}$ percent to $2\frac{3}{4}$ percent over the four quarters of 1992; the central tendency of the forecasts for 1993 spans a range of $2\frac{3}{4}$ to 3 percent. With regard to the unemployment rate, the central tendency of the governors' and Bank presidents' forecasts for the fourth quarter of 1992 covers a range of $7\frac{1}{4}$ to $7\frac{1}{2}$ percent, as compared with the second-quarter average of $7\frac{1}{2}$ percent; the corresponding central tendency range for the final quarter of 1993 is $6\frac{1}{2}$ to 7 percent.

The achievement of the projected GDP growth will depend in part on the progress in resolving the various structural adjustments noted earlier. In general, the Board members and Reserve Bank presidents believe that these structural problems will continue to exert negative drag on the economy in coming quarters, but that their force will gradually lessen. On that score, some of the recent trends have been encouraging.

In the market for commercial real estate, which has been the most striking area of weakness in the economy in recent quarters, downward pressures on the prices of existing properties seem to have begun to diminish, and the rate of decline in new construction appears to be slowing. In addition, businesses and households also have made considerable progress in strengthening their finances, and even though that improvement evidently has not yet generated more expansive attitudes toward spending and investing, such a shift probably will be forthcoming at some point. An obvious risk in the outlook is that these, and the other, structural adjustments could persist with greater intensity than is anticipated; but, alternatively, a faster resolution of the structural problems—and a stronger pickup of the economy—is not out of the question either.

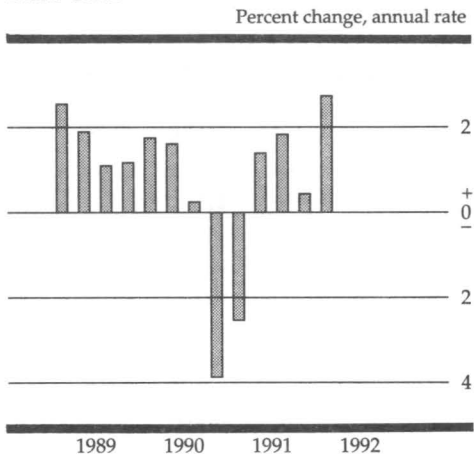
The governors and Bank presidents expect the rise in the consumer price index over the four quarters of 1992 to end up in the range of 3 to $3\frac{1}{2}$ percent. Although an increase of this magnitude is to the high side of that which was realized in 1991, inflation rates were held down last year by the unwinding of the oil price shock that had occurred in 1990.

Core inflation this year is expected to be lower than it was in 1991, and most Board members and Reserve Bank presidents believe that sustained progress toward the containment of costs and a further easing of inflation expectations will keep the trend rate of price increase on a course of gradual slowing next year as well. With neither food nor energy prices anticipated to depart in any meaningful way from the broad trends of inflation, the total CPI also is expected to slow in 1993, dropping into a range of $2\frac{3}{4}$ to $3\frac{1}{4}$ percent, according to the central tendency of the FOMC participants' forecasts.

Earlier this year, in the *Economic Report of the President* and the *Budget*, the Administration issued forecasts that showed nominal GDP growth in 1992 and 1993 that falls within the ranges anticipated by Federal Reserve officials. Consequently, there would appear to be no inconsistency between the System's plans for monetary policy and the short-term goals of the Administration.

Looking more toward the long term, the prospect of a sustained period of declining inflation, together with a resolution of the many structural problems that currently afflict the economy, suggests the opportunity for substantial economic gains and a broadening prosperity.

Real GDP



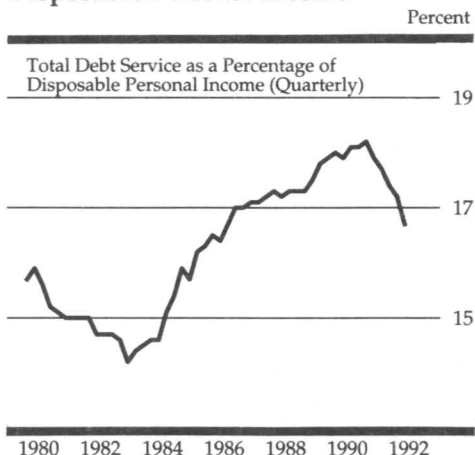
The Federal Reserve, for its part, can best contribute to the achievement of those objectives by keeping its sight firmly on the long-run goal of price stability. But the longer-range progress of American living standards will depend upon more than monetary stability. Sound fiscal policies and an open world trading system are essential if we are to enhance capital formation and achieve the greatest possible productivity of our human and physical resources.

Developments in 1992

Economic activity has increased on balance since the beginning of the year, but rather hesitantly in recent months, and inflationary pressures have continued to abate. Against this backdrop—and with money and credit exhibiting renewed weakness in the second quarter—the Federal Reserve has eased money market conditions twice—in April and again in early July. The descent of domestic interest rates, which began in 1989, has now carried nominal yields on many market instruments to the lowest levels in two or three decades.

In mid-February, when the Board presented its last semiannual report on monetary policy to the Congress, the economy seemed to be struggling to regain forward momentum. Growth had come almost to a standstill in the final quarter of 1991, and, while a hint of improvement was evident in some of the indicators that were available in mid-February, convincing signs of a strengthening of activity had not yet appeared. Moreover, in looking ahead at that time, it seemed likely that growth would continue to be retarded by the still incomplete resolution of major structural adjustments in a variety of sectors, financial and nonfinancial.

Household Sector Debt Service Relative to Disposable Personal Income*



* Debt service is a staff estimate of scheduled principal and interest payments on home mortgage and consumer debt.

Chief among those structural impediments were persistent problems in commercial real estate markets, budgetary stress at all levels of government, a downsizing of the defense industry, exceptional caution among financial intermediaries, and ongoing efforts of businesses and households to reduce the level of their indebtedness.

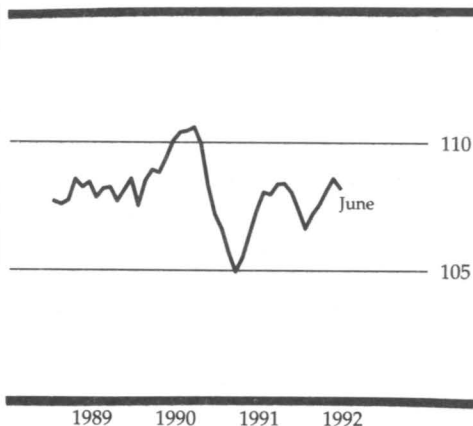
At the same time, however, considerable impetus to activity was thought to be already in train, partly as a result of the substantial easing of money market conditions that the System had implemented in the second half of 1991.

Among other effects, the decline in short- and long-term interest rates was reducing debt-servicing obligations and was facilitating needed balance sheet restructuring by borrowers and lenders. In assessing the situation as of last February, the Board members and Reserve Bank presidents recognized that the uncertainties in the outlook were unusually large; but they believed that a moderate pickup in output from the especially sluggish pace of the fourth quarter of 1991, coupled with further improvement in underlying price trends, was the most likely prospect in 1992.

In the event, economic growth did move back into a moderate range in the first quarter of 1992. After keeping a tight grip on their expenditures during the holiday shopping season, consumers stepped up their spending sharply in early 1992; simultaneously, purchases of new houses soared, spurred in part by lower mortgage interest rates. An unusually mild winter also helped to buoy activity in January and February. Although businesses were able to accommodate much of the burst in spending through a drawdown of inventories, the rise in demand sparked a rebound in industrial output. Consumer sentiment, which had deteriorated in late 1991 and early 1992, began to tilt back up in late winter and early spring, and business executives expressed greater optimism.

Industrial Production

Index 1987 = 100



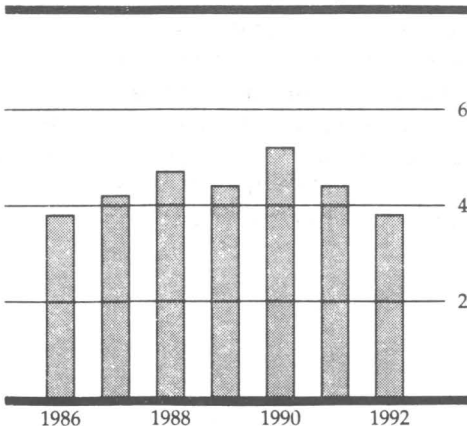
Economic growth, as measured by the annualized rate of change in real gross domestic product, moved up to 2¾ percent in the first quarter, the largest quarterly gain in more than three years.

The strength in final demand that seemed to be emerging in the early part of the year does not appear to have carried through the second quarter, however. Households, restrained by a soft labor market and the lack of significant gains in real income, clamped down on their spending after the burst early in the year; real consumption expenditures appear to have grown little, if at all, in the second quarter, and new home sales fell steadily from February through May. In addition, exports, which, over the past several years, had been an area of strength in the economy, showed little growth over the first five months of 1992.

Although manufacturers boosted production in April and May, they tended to do so more by stretching the hours of their workers, rather than by adding employees to their payrolls. Declines in production became evident in the industrial sector in June, as firms apparently moved quickly to forestall unintended inventory accumulation. In the labor market, the data for May and June showed a disturbing rise in the unemployment rate, to a level of 7.8 percent. On the whole, the growth of total output in the economy likely was positive again in the second quarter—as it had been in each of the four preceding quarters. But, as the Federal Reserve had anticipated at the start of the year, the drag from ongoing structural adjustments has remained heavy.

Consumer Prices Excluding Food and Energy*

Percent change, Dec. to Dec.



*Consumer price index for all urban consumers.

**Percent change, June 1991 to June 1992.

Inflationary forces have been muted this year. Prices accelerated somewhat in the first quarter, but that flare-up proved to be short-lived, as increases in the consumer price index were small, on average, in the second quarter. The “core” rate of inflation, as measured by the change in the CPI excluding food and energy, averaged 3.8 percent at an annual rate in the first six months of 1992; this rate of rise was a little lower than the average rate of increase during 1991, and it was considerably less than the increase seen during 1990. With inflation expectations down appreciably from recent highs, and with firms striving to reduce their costs on all fronts, a trend toward gradual reduction in the rate of price increase appears to be well established at the present time.

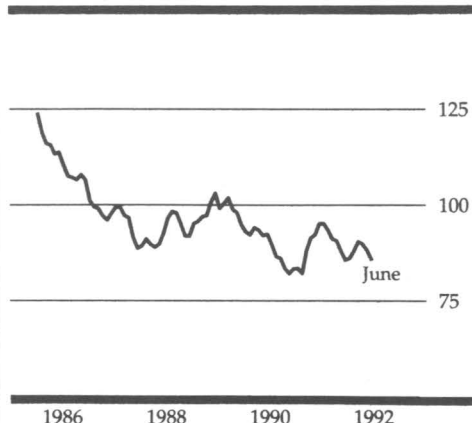
Growth in the broad measures of money was quite weak in the second quarter, leaving both M2 and M3 in June below the lower bounds of their annual ranges. Measured from its average level in the fourth quarter of 1991, M2 increased at an annual rate of 1½ percent through June, while M3 edged down at a rate of ¼ percent over that same period. As is discussed in more detail below, the sluggishness of money during this period seemed to be more a reflection of changing patterns of finance than of restraint on nominal income growth. Still, private credit growth also was relatively slow, and, in the

context of renewed softness in the incoming data on spending and production, the weakness in both money and credit added to concerns about the ongoing strength of the expansion.

In this environment, the System eased money market conditions slightly in April and implemented a one-half percentage point reduction in the discount rate on July 2 along with a commensurate further easing of money market conditions. In total, short-term interest rates have declined about three-quarters of a percentage point since the beginning of the year. Longer-term rates backed up early in the year as the economic expansion appeared stronger than many people had expected, raising market concerns about a revival of inflationary pressures. However, in recent months many bond and mortgage rates have retraced their earlier increases. Broad indexes of stock prices have remained close to record levels. In foreign exchange markets, the weighted average value of the dollar, in terms of the currencies of other Group-of-Ten (G-10) countries, appreciated until early March, but recent depreciation, occasioned primarily by a less robust outlook for the U.S. economy, has left the dollar somewhat below its 1991 year-end level.

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. Weights are based on 1972-76 global trade of each of the 10 countries.

Declining interest rates in recent years have contributed to sizable reductions in debt-service obligations, as both long- and short-term debt has been rolled over or refinanced at lower rates. In addition, lower long-term rates and high price-earnings ratios on stocks have encouraged businesses to reduce the interest-rate risk and the uncertainty associated with short-term funding by relying more heavily on issuance of long-term debt and equity.

Long-Term Interest Rates



Households also have taken advantage of lower rates to refinance existing debt, especially mortgages. In addition, over-leveraged households, facing uncertain income and employment prospects and wide spreads between rates charged on consumer credit and yields on monetary assets, have moved to limit debt growth.

The resulting improvements in the financial conditions of households and businesses are evident in a number of indicators: Delinquencies on consumer loans and home mortgages have declined, ratings for a number of firms have been upgraded, and yield spreads have narrowed on private fixed-income securities relative to Treasury obligations.

Of course, not all parties have benefitted from lower interest rates; households holding short-term deposits have experienced a sizable decline in interest income. On balance, though, lower interest rates have helped households and businesses strengthen their balance sheets, thereby building a firmer financial foundation for future economic expansion.

Efforts to return to more sustainable leverage positions have contributed to slow expansion of the debt of nonfederal sectors in the first half of this year. Heavy borrowing by the federal government has kept total debt expanding at the lower end of the Federal Open Market Committee's (FOMC) 4½ to 8½ percent monitoring range, based on current estimates. Depository credit remains especially weak, reflecting not only muted private loan demands, but also continued caution among depositories. Commercial banks no longer appear to be tightening their non-price terms of lending, but the degree of credit restraint remains substantial and spreads between loan rates and the cost of funds remain unusually wide. Bank capital positions have improved substantially over the past year; nonetheless, banks are likely to continue working to bolster capital, partly as a consequence of incentives contained in the FDIC Improvement Act.

The contraction of depository credit has been mirrored by the meager advance in the monetary aggregates. This is seen clearly in M3, which includes most of the liabilities banks and thrifts use to fund loans and other assets. But M2 also has been affected. Banks and thrifts have not actively pursued deposit funding in light of weak loan growth, and retail deposit rates have fallen considerably over the course of the year. Consumers consequently have sought higher-yielding assets outside M2, including those in the capital market where—despite the greater risks involved—returns have appeared more attractive. In addition, given the wide deposit-loan rate spreads, some M2 holders likely have opted to pay down debt rather than to hold monetary assets.

The rechanneling of credit flows away from depositories and the associated sluggish money growth have not been entirely benign; many borrowers face higher costs and stricter terms of credit now than in the past at given levels of market interest rates. Nonetheless, weakness of the monetary aggregates has not been associated with a similar degree of restraint on aggregate demand. Indeed, growth in nominal spending has considerably outpaced that of M2 and M3; put differently, both monetary aggregates appear to have registered sizable increases in their income velocities in the first half of the year. The rise in M2 velocity is particularly notable, given the marked drop in short-term interest rates in the latter part of 1991. Ordinarily, velocity tends to fall for a time after a decline in short-term rates.

Growth of Money and Debt (Percentage change)

		M1	M2	M3	Debt of Domestic Nonfinancial Sectors
Annually, Fourth quarter to fourth quarter	1980	7.5	8.9	9.5	9.3
	1981	5.4 (2.5)*	9.3	12.3	10.1
	1982	8.8	9.1	9.9	9.3
	1983	10.4	12.2	9.9	11.4
	1984	5.4	8.0	10.8	14.2
	1985	12.0	8.7	7.6	13.9
	1986	15.5	9.2	9.0	14.1
	1987	6.3	4.3	5.9	10.4
	1988	4.3	5.2	6.4	9.4
	1989	0.6	4.8	3.6	8.1
	1990	4.2	4.0	1.7	7.0
	1991	8.0	2.8	1.2	4.4
Quarterly (annual rate) 1992	Q1	16.5	4.3	2.2	3.8
	Q2	9.9	0.0	-1.9	5.1
Semiannually, fourth quarter to second quarter (annual rate) 1992	H1	13.4	2.1	0.2	4.5

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