1994 MONETARY POLICY OBJECTIVES

SUMMARY
REPORT
OF
THE
FEDERAL
RESERVE
BOARD

FEBRUARY 22, 1994

1994 MONETARY POLICY OBJECTIVES

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

FEBRUARY 22, 1994

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Economic Projections for 1994

In general, the governors and Reserve Bank presidents anticipate that 1994 will be another year of progress for the economy, with low inflation and financial market conditions continuing to provide a setting conducive to sustaining moderate economic growth and rising employment opportunities.

The Federal Reserve officials' forecasts of real GDP growth over the four quarters of 1994 span a range of 2½ percent to 3¾ percent, with the central tendency of the forecasts being 3 to 3¼ percent. The governors and Reserve Bank presidents anticipate that the rise in real GDP will be accompanied by a further increase in labor productivity. Nonetheless, employment gains are expected to be sufficient to bring about some further reduction in the degree of labor market slack over the four quarters of the year. Forecasts of the unemployment rate in the fourth quarter of 1994 span a range of 6½ percent to 6¾ percent. Because of changes in survey design, a comparable rate for the fourth quarter of last year is not available; however, the Bureau of Labor Statistics has estimated that the fourth-quarter rate would have exceeded 7 percent on the new basis.

The sectoral composition of growth in 1994 may well resemble that of 1993. The financial adjustments of recent years have left households better positioned and more willing to boost spending. Moreover, with employment rising, real income growth should be supportive of increased consumer expenditures in the coming year, despite the higher taxes confronting some households.

Economic Projections of FOMC Members and Other FRB Presidents for 1994
Percent

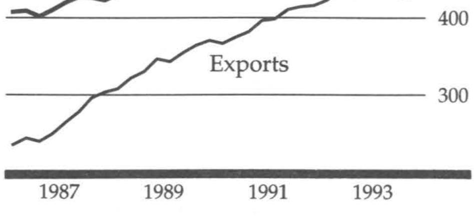
Item		Range	Central tendency
Change, fourth quarter to fourth quarter:[1]	Nominal GDP	4¾–7½	5½–6
	Real GDP	2½–3¾	3–3¼
	Consumer price index[2]	2¼–4	About 3
Average level in the fourth quarter:	Unemployment rate[3]	6½–6¾	6½–6¾

1. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.
2. All urban consumers.
3. Civilian labor force.

Business investment seems likely to be pushed ahead by ongoing efforts to modernize and by further declines in computer prices. By contrast, further cuts in federal outlays for defense likely will continue to be a restraining factor on the growth of aggregate demand. With the passage of time, the more accommodative monetary policies now in place in a number of countries, together with the moderate fiscal stimulus in Japan, are likely to lead to a gradual pickup in the rates of growth of foreign industrial countries and U.S. exports. However, U.S. imports from abroad will likely continue to move up at a brisk pace. Net exports of goods and services thus may decline somewhat further, albeit at a slower rate than they have over the past year.

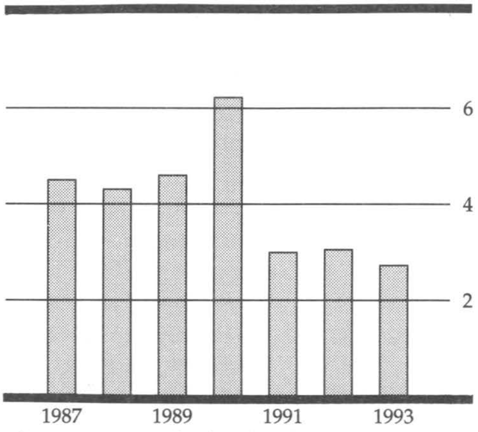
U.S. Real Merchandise Trade

Annual rate, billions of 1987 dollars



Consumer Prices*

Percent change, Q4 to Q4



*Consumer price index for all urban consumers.

The majority of the governors and Bank presidents expect inflation in 1994 to run a shade higher than in 1993. Most of their forecasts for the rise in the consumer price index are close to 3 percent, although the full range of forecasts extends from a low of 2¼ percent to a high of 4 percent. Several developments are likely to work against better inflation performance in 1994. In agriculture, a poor harvest in 1993 has left some crops in very tight supply, and the risk of unfavorable food price developments is greater than it has been in recent years. In addition, although the future course of energy prices is uncertain, a repeat of last year's declines, which helped to hold down the overall CPI, cannot be counted on.

More fundamentally, the recent narrowing of the degree of slack in the labor and product markets suggests that competitive pressures damping wage and price increases will be less strong and less pervasive than they have been recently.

The central tendencies of the forecasts of GDP growth, unemployment, and inflation are quite similar to the projections put forth by the Administration in its recent reports. Moreover, insofar as the Administration's numbers were predicated, in part, on the assumption that short-term interest rates would rise modestly in 1994, the recent tightening action by the Federal Reserve does not appear to be inconsistent with the Administration's outlook.

Prospects for sustained growth over the longer run have been bolstered by policy actions on a number of fronts. Considerable work remains to be done, however. Although recent fiscal measures have been helpful in bringing about declines in the federal budget deficit, the Congress and the Administration still must deal with some difficult issues to ensure that the deficit is kept on a downward course through the latter part of the 1990s and into the next century.

In the area of trade policy, the nation's long-standing support of an open world trading system was reaffirmed this past year in the form of passage of the North American Free Trade Agreement and the agreement in the Uruguay Round—actions that will yield important benefits over time not only to the United States but also to its trading partners. Nonetheless, serious obstacles to free trade still remain. On a wide range of regulatory issues, the Congress and the Administration face decisions that have the potential to promote—or to damage—the flexibility in labor and product markets and the processes of innovation and investment that are so critical to long-run economic progress. In the area of monetary policy, the challenge is to build on the favorable price performance of late in a situation in which the economy will likely be operating closer to full capacity than it has in recent years. With success in keeping the economy on course toward the long-run goal of price stability, the prospects for sustained expansion will be greatly enhanced.

Money and Debt Ranges for 1994

At its July 1993 meeting, the Committee had provisionally chosen the same ranges for 1994 as it had established for 1993—1 to 5 percent for M2 and 0 to 4 percent for M3 and a monitoring range of 4 to 8 percent for the domestic nonfinancial debt aggregate.

At that time, the Committee noted that disturbances to the historical relationships between the aggregates and spending required that the actual determination of these ranges for 1994, in February of this year, be made in light of additional experience and analysis.

Ranges for Growth of Monetary and Debt Aggregates[1]

Percent

	1992	1993	1994
M2	2½–6½	1–5	1–5
M3	1–5	0–4	0–4
Debt[2]	4½–8½	4–8	4–8

1. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated. Ranges for monetary aggregates are targets; range for debt is a monitoring range.
2. Domestic nonfinancial sector.

As noted above, the velocities of M2 and M3 increased further in 1993, but at a slower rate than in the previous year. This deceleration might indicate that the forces that had distorted the aggregates over the past few years, while still potent, were beginning to wane. The yield curve, although quite steep, now offers investors less inducement to move outside M2 in the search for better returns than at any time in the past three years. Additionally, firms, having strengthened their financial positions, may feel more comfortable taking on shorter-term obligations and, so, may direct more of their business to depositories. Banks, which are better capitalized and more liquid, should be in a strong position to meet those needs. Still, capital markets will provide attractive alternatives to the depository sector, suggesting that the forces tending to divert funds from depositories—and to raise the velocities of the monetary aggregates—will continue to be important. However, the strength of these forces, and whether or how quickly they might be abating, remains difficult to judge.

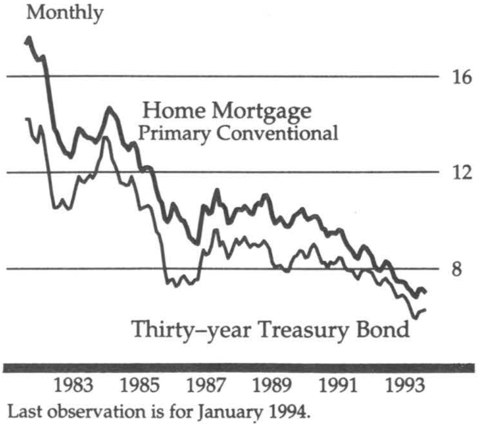
Against this background, the Federal Open Market Committee at its most recent meeting reaffirmed the annual growth ranges for the money and credit aggregates that had been chosen provisionally last July. The annual ranges appear to be sufficiently wide to encompass growth of M2 and M3 consistent with Committee members' expectations for nominal income under a variety of alternatives for the behavior of the velocities of the aggregates. If the forces depressing the demand for money relative to income were to persist unabated in 1994, M2 and M3 might be in the lower portion of their cones; should M2 and M3 move closer to their former alignments with spending—buoying the demands for those aggregates and depressing their velocities—then outcomes in the upper portion of the ranges would be expected. The Committee will watch the monetary aggregates closely during the course of the year for evidence on unfolding economic and financial conditions. But, given uncertainties about velocity behavior, that information will necessarily be assessed in combination with a variety of other financial and economic indicators as the Committee formulates policy. Through 1994, as was true last year, the Committee's primary concern will be to foster financial conditions that help to contain price pressures and to sustain economic expansion, and it will have to assess the rates of money growth consistent with these objectives as the year goes on.

Debt growth, which has moved in closer alignment with nominal income over the past few years than have the monetary aggregates, will again be monitored in light of a 4 to 8 percent annual range. With the federal sector's demands on the pool of saving diminishing, the Committee envisions that an unchanged range would be associated with some pickup in borrowing by the private sector. Healthier balance sheets, lighter debt service burdens, heavier capital spending, and more eager lenders should all act to boost the expansion of nonfederal debt. Overall, the debt of the nonfinancial sectors is expected to grow again at about the pace of nominal income.

Monetary and Financial Developments in 1993

Nineteen ninety-three turned out to be a favorable year for the U.S. economy, with notable gains in real output, declines in joblessness, and a further small drop in the rate of inflation. Financial conditions conducive to growth prevailed throughout 1993 and gave considerable impetus to activity. With the Federal Reserve keeping reserve market pressures unchanged, short-term interest rates held steady during the year at unusually low

Long–Term Interest Rates

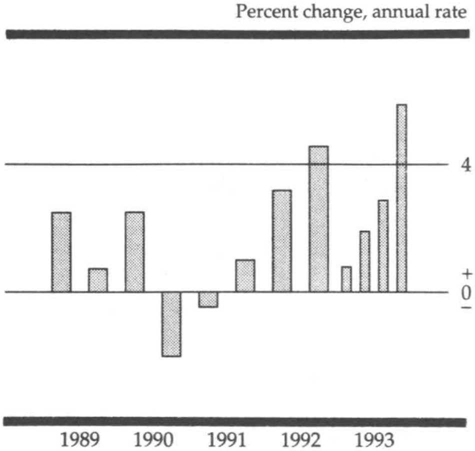


Last observation is for January 1994.

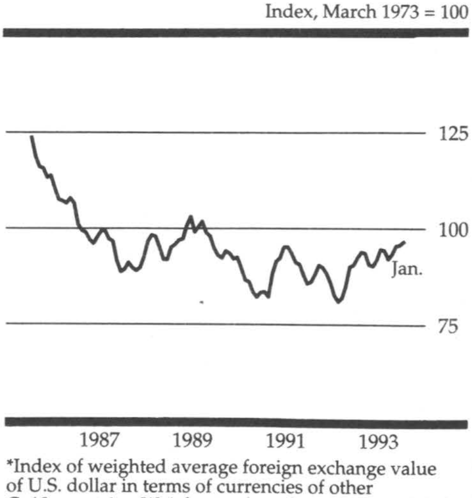
levels, especially when measured relative to inflation or inflation expectations. In addition, long-term rates declined further, partly in response to actions taken by the Congress and the Administration to put the federal deficit on a more favorable trend.

Against this backdrop, households and businesses were able to take further steps to reduce the burden of servicing debt, and more expansive attitudes toward spending and the use of credit seemed to take hold. Spending in the interest-sensitive sectors of the economy surged ahead, with particularly large advances in residential investment, business outlays for fixed capital, and consumer durables. The growth of real GDP picked up sharply in the second half, and the increases for all of 1993 cumulated to about 2¾ percent according to initial estimates. In the labor market, employment moved up at a moderate pace, and the unemployment rate dropped almost a percentage point over the year. As measured by the consumer price index, the rate of inflation edged lower last year, as unfavorable reports in the first few months of 1993 gave way to more subdued readings thereafter. The performance of the U.S. economy stood in sharp contrast to the continued sluggish growth in many of the other industrial countries and helped to buoy the trade-weighted value of the dollar on foreign exchange markets.

Real GDP



Foreign Exchange Value of the U.S. Dollar*



*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.

In conducting policy through 1993, the Federal Open Market Committee recognized that it was maintaining a very accommodative stance in reserve markets. Reserve conditions had been eased to this degree over the prior four years to counter the effect of some unusual factors restraining aggregate demand. The Committee recognized that, as these forces abated, short-term interest rates would likely have to rise to forestall inflationary pressures that would eventually undermine the expansion.

Toward the end of 1993 and into early 1994, incoming data on the economy and credit flows have increasingly conveyed a picture of considerable underlying strength. The marked speedup of growth in the economy has been reducing spare capacity, as is evident in the recent declines in unemployment and increases in capacity utilization rates in industry. Moreover, while movements in broadly based price indexes have remained relatively favorable, there also have been undercurrents suggesting that the process of disinflation might be stalling out. In particular, after slowing considerably in 1992, nominal increases in hourly compensation—comprising wages and benefits—fell no further in 1993, and long-term inflation expectations remain stubbornly above recent inflation rates. Also, commodity prices generally have firmed in recent months.

Earlier this month, the Federal Reserve concluded that the weight of the evidence indicated that undiminished monetary stimulus posed the threat that capacity pressures would build in the foreseeable future to the point where imbalances would develop and inflation would begin to pick up. At its February 1994 meeting, the Federal Open Market Committee determined that it was time to move to a slightly less accommodative stance. While the discount rate remained at 3 percent, the federal funds rate edged up to trade around 3¼ percent, a little above the prevailing rate of inflation.

Strength in spending last year was supported by increased borrowing by both households and businesses. Continuing declines in a number of interest rates, which sparked considerable refinancing of existing obligations, helped to trim debt service burdens for both sectors, undoubtedly facilitating the pickup in borrowing and spending. Indicators of financial stress, including loan default rates and bankruptcy filings, took a decided turn for the better in 1993. Borrowing by households was robust enough to raise the ratio of debt to disposable income; business debt, held down in part by equity issuance, declined relative to income. The debt of all nonfinancial sectors is estimated to have grown about 5 percent last year, the same as in 1992, as a diminution in the net funding needs of the federal government was about offset by the pickup in private demands. This growth placed the debt aggregate in the lower half of its 4 to 8 percent monitoring range.

The growth of M2 slowed in 1993, albeit considerably less than the deceleration in nominal GDP. For the year, M2 advanced 1½ percent, placing it a little above the lower bound of its 1 to 5 percent annual growth cone. M3 expanded ½ percent, the same pace as in 1992, and a bit above the lower bound of its 0 to 4 percent annual range. The ranges had been adjusted down by the Federal Open Market Committee during 1993. The adjustments were technical in nature and reflected the Committee's judgment as to the extent of the ongoing distortions of financial flows relative to historical patterns, and of consequent increases in velocities—that is, the ratios of nominal GDP to money.

The special factors shaping the growth of the monetary aggregates included a marked preference by borrowers for capital market financing, rather than bank loans, and a configuration of market returns that enticed investors away from the traditional financial products offered by depositories. Bond and stock mutual funds were the primary beneficiaries of this shift, with inflows into such funds in 1993 setting a new record. This continuing redirection of credit flows has rendered the movements of the broad monetary aggregates less representative of the pace of nominal spending than was evident in the longer historical record. In 1993, nominal GDP grew a shade more than 5 percent, or 3¾ percentage points above the rate of expansion of M2 and 4½ percentage points above that of M3.

Most of the increase in the broad aggregates was recorded in their M1 component, which grew 10½ percent in 1993, as low money market and deposit interest rates provided little reason to forgo the liquidity of transaction deposits. At times during the year, declines in longer-term market rates produced waves of mortgage refinancing, an activity that is associated with temporary flows through the transaction deposits that are counted in M1. In addition, the currency component expanded at about the same rate as the M1 total, spurred by considerable demands from abroad. The double-digit expansion in M1 deposits pushed reserves up at a 12½ percent rate in 1993, while the monetary base, which includes reserves and currency, increased 10½ percent, the same rate that was posted in the previous year.

Growth of Money and Debt

Percent

		M1	M2	M3	Domestic Nonfinancial Debt
Annual, Fourth quarter to fourth quarter[1]	1980	7.4	8.9	9.6	9.1
	1981[2]	5.4 (2.5)	9.3	12.4	9.9
	1982	8.8	9.2	9.9	9.6
	1983	10.4	12.2	9.9	12.0
	1984	5.5	8.1	10.9	14.0
	1985	12.0	8.7	7.6	14.2
	1986	15.5	9.3	8.9	13.4
	1987	6.3	4.3	5.7	10.3
	1988	4.3	5.3	6.3	9.0
	1989	0.6	4.8	3.8	7.8
	1990	4.2	4.0	1.7	6.6
	1991	7.9	2.9	1.2	4.6
	1992	14.3	1.9	0.5	5.0
	1993	10.5	1.4	0.6	4.9
1993 Quarter *(annual rate)*[3]	Q1	8.3	–1.3	–3.2	4.0
	Q2	10.7	2.2	2.1	4.5
	Q3	12.0	2.6	1.1	5.7
	Q4	9.4	2.1	2.4	5.2

1. From average for fourth quarter of preceding year to average for quarter of year indicated.
2. M1 adjusted for shifts to NOW accounts in 1981.
3. From average for preceding quarter to average for quarter indicated.

Testimony of Alan Greenspan Chairman, Federal Reserve Board

Mr. Chairman and members of the Subcommittee, I am pleased to appear today to present the Federal Reserve's semiannual monetary policy report to the Congress.

In the seven months since I gave the previous Humphrey–Hawkins testimony, the performance of the U.S. economy has improved appreciably. Private-sector spending has surged, boosted in large part by very favorable financial conditions. With mortgage rates at the lowest level in a quarter century, housing construction soared in the latter part of 1993. Consumer spending, especially on autos and other durables, has exhibited considerable strength. Business fixed investment has maintained its previous rapid growth. Important components of GDP growth in the second half of last year represented one-time upward adjustments to the level of activity in certain key sectors, and, with output in these areas unlikely to continue to climb as steeply, significant slowing in the rate of growth this year is widely expected. In addition, the Southern California earthquake and severe winter weather may have dulled the force of the favorable trends in spending in January and February. Nonetheless, as best we can judge, the economy's forward momentum remains intact.

The strengthening of demand has been accompanied by favorable developments in labor markets. In the second half of the year, employment continued to post moderate gains, and the unemployment rate fell further, bringing its decrease over the full year to nearly 1 percentage point. The unemployment rate in January apparently declined again on both the old and new survey bases.

On the inflation front, the deterioration evident in some indicators in the first half of 1993 proved transitory. For the year as a whole, the Consumer Price Index rose 2¾ percent, the smallest increase since the big drop in oil prices in 1986. Broader inflation measures covering purchases by businesses as well as consumers rose even less. While declining oil prices contributed to last year's good readings, inflation measured by the CPI excluding food and energy also diminished slightly further, to just over a 3 percent rate for the whole year. In January the CPI remained quite well behaved on the whole. Not all signs have been equally favorable, however. For example, a number of commodity prices have firmed noticeably in recent months. And indications that such increases may be broadening engendered a back-up in long-term interest rates in recent days. In particular, the Philadelphia Federal Reserve Bank's survey showing a marked increase in prices paid by manufacturers early this year was taken as evidence of a more general emergence of inflation pressures.

It is important to note, however, that in the past such price data have often been an indication more of strength in new orders and activity than a precursor of rising inflation throughout the economy. In the current period, overall cost and price pressures still appear to remain damped. Wages do not seem to be accelerating despite scattered reports of some skilled-worker shortages, and advances in productivity early this year are holding down unit labor costs. Moreover, while private borrowing has picked up, broad money—to be sure a highly imperfect indicator of inflation in recent years—has continued to grow slowly.

Nonetheless, markets appear to be concerned that a strengthening economy is sowing the seeds of an acceleration of prices later this year by rapidly eliminating the remaining slack in resource utilization. Such concerns were reinforced by forecasts that recent data suggest that revised estimates of fourth-quarter GDP to be released next week will show upward revisions from the preliminary 5.9 percent annual rate of growth. Rapid expansion late last year, it is apparently feared, may carry over into a much smaller deceleration of activity in 1994 than many had previously expected.

But it is too early to judge the degree of underlying economic strength in the early months of 1994. Anecdotal evidence does indicate continued underlying strength in manufacturers' new orders and production, but we will have a better reading on new orders on Thursday when preliminary data for January are released.

The labor markets are signalling a somewhat less buoyant degree of activity as initial claims for unemployment insurance in recent weeks have moved up a notch. Clearly, the Federal Reserve will have to monitor carefully ongoing developments for indications of potential inflation or a strengthening in inflation expectations. As I have often noted, if the Federal Reserve is to promote long-term growth, we must contribute, as best we can, to keeping inflation pressures contained.

In this regard, a clear lesson we have learned over the decades since World War II is the key role of inflation expectations in the inflation process and in the overall performance of the macroeconomy. As I indicated in my testimony before the Joint Economic Committee last month, until the late 1960s, economists often paid inadequate attention to expectations as a key determinant of inflation. Unemployment and inflation were considered simple tradeoffs. A lower rate of unemployment was thought to be associated with a higher, though constant, rate of inflation; conversely, a higher rate of unemployment was associated with a lower rate of inflation.

But the experience of the past three decades has demonstrated that what appears to be a tradeoff between unemployment and inflation is quite ephemeral and misleading. Attempts to force-feed the economy beyond its potential have led in the past to rising inflation as expectations ratcheted higher and, ultimately, not to lower unemployment, but to higher unemployment, as destabilizing forces and uncertainties associated with accelerating inflation induced economic contraction. Over the longer run, no tradeoff is evident between inflation and unemployment. Experience both here and abroad suggests that lower levels of inflation are conducive to the achievement of greater productivity and efficiency and, therefore, higher standards of living.

In fact, lower inflation historically has been associated not just with higher levels of productivity, but with faster growth of productivity as well. Why inflation and productivity growth are linked this way empirically is not clear. To some extent higher productivity growth may help to damp inflation for a time by lessening increases in unit labor costs. But the process of cause and effect in all likelihood runs the other way as well. Lower inflation and inflation expectations reduce uncertainty in economic planning and diminish risk premiums for capital investment. They also clarify the signals from movements in relative prices, and they encourage effort and resources to be devoted to wealth creation rather than wealth preservation. Many people do not have the knowledge of, or access to, ways of preserving wealth against inflation; for them, low inflation avoids an inequitable erosion of living standards.

The reduced inflation expectations of recent years have been accompanied by lower bond and mortgage interest rates, slower actual inflation, falling unemployment, and faster trend productivity growth. The implication is clear: when it comes to inflation expectations, the nearer zero, the better.

It follows that price stability, with inflation expectations essentially negligible, should be a long-run goal of macroeconomic policy. We will be at price stability when households and businesses need not factor expectations of changes in the average level of prices into their decisions. How those expectations form is not always easy to discern, and they can for periods of time appear to be at variance with underlying economic forces. But history tells us that it is economic and financial forces and their consequences for realized inflation that ultimately shape inflation expectations.

Fiscal and monetary policy are important among those forces and have contributed to the decline in inflation expectations in recent years along with decreases in long-term interest rates. The actions taken last year to reduce the federal budget deficit have been instrumental in this regard. Although we may not all agree on the specifics of the deficit reduction measures, the financial markets are apparently inferring that, on balance, the federal government will be competing less vigorously for private saving in the years ahead. Concerns that the deficit is out of control have diminished. In the extreme, explosive federal debt growth makes an eventual resort to the printing press and inflationary finance difficult to resist. By shrinking any perceived risk of this outcome, the deficit reduction package apparently had a salutary effect on longer-term inflation expectations.

The Federal Reserve's policies in recent years also have helped to damp inflation and inflation expectations. We were able to do so, even while adopting an increasingly accommodative policy stance. By placing our actions in the context of a thorough analysis of the prevailing situation and of a longer-term underlying strategy, our move to greater accommodation could be seen as what it was—a deliberate effort to counter the various "headwinds" that were retarding the advance of the economy rather than a series of short-term actions taken without consideration for potential inflation consequences over time.

As I discussed with this Subcommittee last July, this longer-run strategy implies that the Federal Reserve must take care not to overstay an accommodative stance as the headwinds abate. But determining when a policy stance is becoming too accommodative is not an easy matter.

Unfortunately, although subdued inflation is the hallmark of a successful monetary policy, current broad inflation readings are actually of limited use as a guide to the appropriateness of current instrument settings. Patently, price measurements over short time spans are subject to transitory special factors. More important, monetary policy affects inflation only with a significant lag. That a policy stance is overly stimulative will not become clear in the price indexes for perhaps a year or more. Accordingly, if the Federal Reserve waits until actual inflation worsens before taking countermeasures, it would have waited far too long. At that point, modest corrective steps would no longer be enough to contain emerging economic imbalances and to avoid a build-up of inflation expectations and a significant back-up of long-term interest rates. Instead, more wrenching measures would be needed, with unavoidable adverse side effects on near-term economic activity.

Inflation expectations likely have more of a forward-looking character than do measures of inflation itself, and, in principle, could be used as a direct guide to policy. But available surveys have limited coverage and are subject to sampling error. As I have testified previously, price-indexed bonds of various maturities, which would indicate underlying market inflation expectations, would be a useful adjunct to our information base for making monetary policy, providing there were a sufficiently broad and active market for them. In addition, the price of gold, which has been especially sensitive to inflation concerns, the exchange rate, and the term structure of interest rates can give important clues about changing expectations.

Of course, a number of factors in addition to inflation expectations affect all of these indicators to a degree. Short- and long-term rates, for example, tend to be highly correlated through time, in part because they are responding to the same business cycle pressures. Thus, when the Federal Reserve tightens reserve market conditions, it is not surprising to see some upward movement in long-term rates, as an aspect of the process that counters the imbalances tending to surface in the expansionary phase of the business cycle. The test of successful monetary policy in such a business-cycle phase is our ability to limit the upward movement of long-term rates from what it would otherwise have been with less effective policy. Moderate to low long-term rates, with rare exceptions, are an essential ingredient of sustainable long-term economic growth. When we take credible steps to head off inflation before it can begin to intensify, the effects on long-term rates are muted. By contrast, when Federal Reserve action is seen as lagging behind the need to counter a buildup of inflation pressures, long rates have tended to move sharply higher, as eventually happened in the late 1970s.

This suggests an important conclusion: Failure to tighten in a timely manner will lead to higher than necessary nominal long-term rates as inflation expectations intensify. Ultimately, short-term rates will be higher as well if policy initiatives lag behind inflation pressures. The higher short-term rates are required not only to take account of rising inflation expectations, but also to provide the additional restraint on real rates necessary to reverse the destabilizing inflation process.

For decades, the monetary aggregates, especially M2, provided generally reliable early warning signals of emerging inflationary imbalances. But, as I have discussed in detail in previous testimonies and will touch on later in this statement, the signals they have sent in recent years have been effectively jammed by structural changes in financial markets and the unusual nature of the current business cycle.

Our monetary policy strategy must continue to rest, then, on ongoing assessments of the totality of incoming information and appraisals of the probable outcomes and risks associated with alternative policies. Our purpose over the longer run is to help the economy grow at its greatest potential over time. To do so, we must move toward a posture of policy neutrality—that is, a level of real short-term rates consistent with sustained economic growth at the economy's potential. That level, of course, is difficult to discern and, obviously, is not a fixed number but moves with developments within the economy and financial markets.

Over a period of several years starting in 1989, the Federal Reserve progressively eased its policy stance, in the process reducing real short-term interest rates to around zero by the autumn of 1992. We undertook those easing actions in response to evidence of a variety of unusual restraints on spending. Households and nonfinancial businesses on the borrowing side and many lenders, including depository institutions, were suffering from balance-sheet strains. These difficulties stemmed from previous overleveraging combined with reductions in net worth from impairments to asset quality, through, for example, falling values of commercial real estate. Corporate restructuring and defense cutbacks compounded the problems of the economy by reducing job opportunities and fostering a more general sense of insecurity about employment prospects.

The deliberate maintenance of low short-term rates for a considerable period was intended to decrease the drag on the economy created by these headwinds. Households and businesses could refinance outstanding debt at much reduced interest cost. In addition, lower rates and improved performance by borrowers would take the pressure off of depository institutions, helping them recapitalize.

Low interest rates, along with reduced financial strains, would encourage private spending to pick up the slack left by defense cutbacks. Once financial positions were well on the road to recovery, and employment and confidence began to recover, it was believed that the economic expansion would gain self-sustaining momentum. At that point abnormally low real short-term real rates should no longer be needed.

As the Federal Open Market Committee (FOMC) surveyed the evidence at its February 4 meeting, a consensus developed that the balance of risks had, in fact, shifted. Debt repayment burdens had been lowered enough to unleash strong aggregate demand in the economy. Real short rates close to zero appeared to pose an unacceptable risk of engendering future problems. We concluded that our policy stance could be made slightly less accommodative without threatening either the continued improvement in balance-sheet structures or, ultimately, the achievement of solid economic growth. Indeed, the firming in reserve market pressures was undertaken to preserve and protect the ongoing economic expansion by forestalling a future destabilizing buildup of inflationary pressures, which in our judgment would eventually surface if the level of policy accommodation that prevailed throughout 1993 were continued indefinitely. We viewed our move as low-cost insurance.

The projections of the FOMC members suggest a continuation of good economic performance in 1994, with reasonable growth and subdued inflation. The central tendencies of the economic forecasts made by governors and Bank presidents imply expectations that economic growth this year likely will be 3 percent or slightly higher. With this kind of growth, a further edging down of the unemployment rate from its January reading is viewed as a distinct possibility. Inflation, as measured by the overall CPI, is seen as rising only a little compared with 1993, even though last year's benefit from falling oil and tobacco prices may not be repeated, and last year's crop losses could buoy food prices in 1994.

There are, of course, considerable risks to this generally favorable outlook. Some observers have pointed to downside risks to economic activity associated with fiscal restraint and weak foreign economies; I believe these factors will have some effects, but they are likely to be less than feared. As for fiscal restraint, a good portion of the negative impact of last year's budget bill may already be behind us, as some households and businesses have adjusted their behavior to the new structure of taxes and to curtailments in defense and other budget programs.

The concern about weak foreign economies relates to the strength of foreign demand for U.S. exports going forward. Many of our major trading partners have been experiencing economic difficulties. But some already appear to be pulling out of recession and a number of others seem to have improved prospects. Moreover, containing inflation will keep increases in production costs of traded goods made in the United States subdued, so that our products will remain competitive in world markets. With competitive goods and an improving world economy, the growth of U.S. exports should strengthen this year, lessening the drag from the external sector on our output growth.

There are upside risks as well. Inventories have reached a low level relative to sales, suggesting the possibility of a boost to production from inventory rebuilding beyond that currently anticipated. In addition, with both borrowers and lenders in stronger financial condition, low interest rates have proven a powerful stimulant to spending. While we were reasonably convinced at the last FOMC meeting that a zero real federal funds rate put real short rates below a "neutral" level, we cannot tell this Subcommittee, with assurance, precisely where the level of neutrality currently resides. To promote sustainable growth, history suggests that real short-term rates are more likely to have to rise than fall from here. I cannot, however, tell you at this time when any such rise would occur; I would hope that part of any increase in real short-term rates ultimately would be accomplished through further declines in inflation expectations rather than through higher nominal short-term rates.

In assessing our policy stance, we will continue to monitor developments in money and credit, but in 1994 as in 1993 the FOMC is unlikely to be able to put a great deal of weight on the behavior of these aggregates relative to their ranges. We have set the ranges as best we can in an evolving financial situation to be consistent with our objectives for sustained growth and low inflation.

Based on our experience in 1993 and expectations about financial relationships for 1994, the FOMC judges that the growth of money and credit this year will stay within the annual ranges set provisionally last July, which were reaffirmed at its meeting early this month. Specifically, these ranges call for growth of 1 to 5 percent for M2, 0 to 4 percent for M3, and 4 to 8 percent for domestic nonfinancial sector debt. The ranges are the same as the final specifications established last July for 1993.

The final specifications for last year had gone through two rounds of technical downward adjustment after they were first set provisionally in July 1992.

These downward revisions reflected the FOMC's recognition that the relationship between spending and money holdings was departing markedly from historical norms. Financial intermediation was moving away from past patterns, as flows of funds were increasingly being rechanneled away from banks toward securities markets, notably via bond and stock mutual funds. Also, banks were relying more heavily on non-deposit funding sources, such as equity and subordinated debt, as they strengthened their capital positions.

In the event, growth of M2 and M3 last year came in above the lower bounds of their reduced ranges with only ½percentage point to spare. M2 grew at 1½ percent and M3 at ½ percent over the year as a whole. Even so, nominal GDP advanced more than 5 percent over the year, extending rapid increases in the velocities of broad money through another year. The discrepancy between the growth rates of nominal GDP and broad money diminished some from that of 1992, but was still unusual in the face of steady short-term interest rates.

Somewhat faster growth of M2 and M3 this year than last year may be in prospect. The governors' and presidents' outlook calls for a small stepup in nominal spending, and the factors depressing growth of the broader aggregates relative to the expansion of spending could well abate to some degree. In particular, the diversion of savings from retail deposits and money funds toward bond and stock mutual funds may lessen, as household portfolios more fully complete the adjustment to the latter's heightened availability. Now that banks have achieved healthier capitalization, they may more readily issue large time deposits instead of equity and subordinated debt to support stepped-up loan growth. Just how far these developments will go, however, is difficult to predict, so the prospective relationship between spending and broad money remains highly uncertain. The FOMC will continue to monitor the behavior of money supply measures for evidence about underlying economic and financial developments more generally, but it will still have to base its assessments regarding appropriate policy actions on a wide variety of economic indicators.

Among those indicators, the Federal Reserve will again pay attention to credit market developments, especially for any light they can shed on the strength of household and corporate balance sheets and spending propensities. The overall debt aggregate put in a repeat performance last year, again growing by around 5 percent, even as the advance of nominal GDP moderated to a similar pace. But this steady debt growth incorporated an upturn in private borrowing, as the borrowing of the federal government slackened.

Households in particular showed a heightened willingness to take on debt to help finance strong purchases of homes and consumer durables. At the same time, massive mortgage refinancings at much reduced interest rates contributed to further reductions in household debt-service burdens relative to income to a level last seen in the mid-1980s. For businesses as well, the bite taken out of cash flow by interest payments was shrunk to a size last observed in the mid-1980s, partly through the refinancing of higher-cost debt and continued equity issuance. Although business borrowing firmed a little, it remained subdued, as enough internal funds were available to finance the bulk of hefty capital expenditures.

Looking ahead, federal borrowing is scheduled to diminish further this year, partly reflecting deficit reduction measures. Borrowing by nonfederal sectors should continue to strengthen, prodded by the anticipated pickup in nominal GDP and the healthier financial condition already attained by households and businesses.

In conclusion, the Federal Reserve has welcomed both the strengthening in activity and the generally subdued price trends, because the intent of our monetary policy in recent years has been to foster precisely this kind of healthy economic performance. Looking forward, our policy approach will be to endeavor to select on a continuing basis the monetary instrument settings that will minimize economic instabilities and maximize living standards over time. The outlook, as a result of subdued inflation and still low long-term interest rates, is the best we have seen in decades. It is important that we do everything we can to turn that favorable outlook into reality.