Income and Consumption • Private Housing

estment • Industrial Production • Change in

1996

Tax Profit Share of Gross Domestic Product •

MONETARY

Real State and Local Expenditures • Real GDP

POLICY

ds and Services • U.S. Current Account • Net

OBJECTIVES

xchange Value of the U.S. Dollar • Change in

Consumption • Change in Employment Cost

l Energy • Consumer Prices • Federal Unified

Summary Report of the Federal Reserve Board

S. and Foreign Interest Rates • Interest Expense

February 20, 1996

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

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Contents

Testimony of Alan Greenspan Chairman, Federal Reserve Board

I appreciate the opportunity to appear before this Committee to present the Federal Reserve's semiannual report on monetary policy.

The United States economy performed reasonably well in 1995. One-and-three-quarter million new jobs were added to payrolls over the year, and the unemployment rate was at the lowest sustained level in five years. Despite the relatively high level of resource utilization, inflation remained well contained, with the consumer price index rising less than 3 percent—the fifth year running at 3 percent or below. A reduction in inflation expectations, together with anticipation of significant progress toward eliminating federal budget deficits, was reflected in financial markets, where long-term interest rates dropped sharply and stock prices rose dramatically over the year.

This outcome was influenced in part by monetary policy actions taken by the Federal Reserve in recent years. Responding to evidence that inflationary pressures were building, we progressively raised short-term interest rates over 1994 and early 1995. Rates had been purposely held at quite low, stimulative levels in 1993. We moved in 1994 to levels more consistent with sustainable growth. Our intent was to be preemptive—to head off an incipient increase in inflationary pressures and to forestall the emergence of imbalances that so often in the past have undermined economic expansions.

As we entered the spring of 1995, it became increasingly evident that our policy was likely to succeed. Although various price indexes were rising a bit more rapidly, there were indications that pressures would not continue to intensify, and might even reverse to a degree. Moderating overall demand growth left businesses with excess inventories. In response, firms initiated production cutbacks to prevent serious inventory imbalances, and the growth of economic activity slowed substantially. With inflation pressures apparently receding, the previous degree of restraint in monetary policy was no longer deemed necessary, and the Federal Open Market Committee consequently implemented a small reduction in reserve market pressures last July.

During the summer and early fall, aggregate demand growth strengthened. As a result, business stocks of raw materials and finished goods appeared somewhat better aligned with sales. In sum, the economy, as hoped, appeared to have moved onto a trajectory that could be maintained—one less steep than in 1994, when the rate of growth was clearly unsustainable, but one that nevertheless would imply continued significant growth in employment and incomes.

Importantly, the performance of the economy seemed to be consistent with maintaining low inflation. Despite the step-up in growth and the relatively high levels of resource utilization, measured inflation abated a little, and many of the signs that had been pointing toward greater price pressures gradually disappeared. Expectations of both near- and longer-term inflation fell substantially over the second half of the year, as gauged by survey results as well as by the downward movements in longer-term interest rates. The fall in bond rates was also encouraged by improving prospects for significant progress in reducing the federal budget deficit. The declines in actual and expected inflation meant that maintaining the existing nominal federal funds rate would raise real short-term interest rates, implying a slight effective firming in the stance of monetary policy. Such a shift would have been particularly inappropriate because economic growth near the end of the year seemed to be slowing, and some FOMC members were concerned about the risks of prolonged sluggishness. Consequently, the Committee decided in December that a further reduction in the funds rate was warranted.

Information becoming available in late December and January raised additional questions about the prospective pace of expansion. The situation was difficult to judge, partly because economic statistics were more sparse than usual, owing mainly to the government shutdowns. In addition, harsh weather in January disrupted both data flows and patterns of economic activity. But several indicators—including initial claims for unemployment insurance, purchasing managers' surveys, and consumer confidence measures—appeared to signal some softening in the economy. Consonant with this pattern, some Reserve Bank Presidents reported that they seemed to be detecting anecdotal indications of weakness in the expansion within their districts with somewhat greater frequency than previously. Moreover, growth in several of our major trading partners seemed to be lagging, which could tend to moderate demand for exports.

A number of factors have prompted the recent tendency toward renewed weakness. Some are clearly quite transitory—related, for example, to bad weather or the federal government shutdown. Others may be somewhat more significant, but still temporary. The constraint on government spending while permanent budget authorizations are being negotiated is one. Another may be a temporary reduction in output in some industries as businesses have further adjusted inventories to disappointing sales.

As I noted last July, the change in the pace of inventory investment when the economy shifts gears can be substantial. Inventory investment surged in 1994 and into the early months of 1995, but proceeded to fall markedly throughout the rest of the year. This has placed significant downward pressure on output, which should lift as inventory adjustments subside. But for the moment, the pressures remain, in the motor vehicle industry and elsewhere.

Ultimately, of course, it is the path of final demand after the temporary influences work themselves out that determines the trajectory of the economy. There are some factors, such as high consumer debt levels, that may be working to restrain spending. But as I shall be detailing shortly, a number of fundamentals point to an economy basically on track for sustained growth, so any weakness is likely to be temporary. Nonetheless, the Committee decided in late January that the evidence suggested sufficient risk of subpar performance going forward to warrant another slight easing of the stance of monetary policy. Given the subdued trends in costs and wages, the odds that such a move would boost inflation pressures seemed low.

In assessing the likely course of the economy and the appropriate stance of policy, one question is the significance, if any, of the age of the business expansion. Some analysts, viewing recent weakness, have observed that the expansion is approaching the start of its sixth year and is now one of the longer peacetime spans of growth in the past half century. Economic expansions, however, do not necessarily die of old age. Although the factors governing each individual business cycle are not always clear, expansions usually end because serious imbalances eventually develop.

When aggregate demand exceeds the economy's potential, for example, inflationary pressures pick up. The inevitable increase in market interest rates, as inflation expectations rise and price pressures intensify, depresses final demand. Lagging demand in turn sets off an inventory correction that frequently triggers a downturn in the economy. As I noted, we acted in 1994 to forestall such a process. Monetary policy began to tighten in advance of the buildup of inflationary pressures and, at least to date, these pressures appear to have been held in check.

Capital expenditures by households and firms can also contribute significantly to the development of cycle-ending imbalances. The level of stocks of such real assets have effects on output very similar to those of business inventories. In typical cycles, capital expenditures tend to grow rapidly in the early stages of recovery: Pent-up demands coming out of a recession by consumers and businesses are satisfied by rapid growth of spending on capital assets.

There is a limit, however, on, say, how many cars people choose to own, or how many square feet of floor space retailers need to service customers. Spending on such assets generally tends to grow more slowly after the pent-up demand is met. As with business inventories, the downshifting of spending on consumer durable goods or business plant and equipment may not occur smoothly. The dynamics of expanding output and rising profit expectations often create a degree of exuberance which, as in much of human nature, tends on occasion to excess—in this case, in the form of a temporary over-accumulation of assets. The ensuing correction in demand for such assets triggers production adjustments that can significantly mute growth for a time or even cause a downturn if the imbalances are large enough.

The current extent of any asset overhang is difficult to determine. The growth of demand for durables and some categories of capital goods evidently has slowed, but the available evidence does not suggest a degree of saturation in capital assets that would tip the economy into a downturn.

Moreover, financial conditions are likely to be generally supportive of spending. The low level of long-term interest rates should have an especially favorable effect. Low rates increase the affordability of housing for consumers and foster investment in productive plant and equipment by businesses. The decline in interest rates also has contributed to a pronounced rise in stock prices. The spread of mutual fund investments has meant that the gain in wealth as financial asset prices have risen has been shared by an ever-wider segment of households. These developments should tend to counter, in part, the depressing effects on spending of rising debt burdens. In addition, with the condition of most financial institutions strong, lenders are likely to remain willing to extend credit to firms and households on favorable terms. We have seen some move by lenders toward tighter standards, but these actions are a modest correction after a marked swing toward ease and should not constrain the availability of funds to creditworthy borrowers.

Against this backdrop, Federal Reserve policymakers expect the most likely outcome for 1996 as a whole is further moderate growth. On the new chain-weighted basis, the central tendency of the forecasts of Board members and Reserve Bank Presidents is for real gross domestic product to expand 2 to 2¼ percent on a fourth-quarter to fourth-quarter basis, similar to the Administration's outlook. With output expanding roughly in line with standard estimates of the increase in the productive capacity of the economy, the unemployment rate is expected to remain around recent levels, as is also forecast by the Administration.

The Federal Open Market Committee expects a continuation of reasonably good inflation performance in 1996. The success during 1995 in keeping the increase in the consumer price index below 3 percent in the fifth year of an expansion illustrates that an extended period of growth with low inflation is possible. And most on the Committee anticipate consumer price inflation at or somewhat below 3 percent in 1996. Although well-known biases in the CPI, as well as the more favorable price performance of business equipment, which is not included in that index, indicate that the true rate of inflation for the whole economy would be significantly lower than 3 percent, the Committee recognized that its expectations for inflation do not imply that price stability has as yet been reached. Nonetheless, keeping inflation from rising significantly during economic expansions will permit a gradual ratcheting down of inflation over the course of successive business cycles that will eventually result in the achievement of price stability.

To emphasize its continued commitment to price stability, the Committee chose to reaffirm the relatively low ranges for money growth in 1996 that it had selected on a provisional basis last July. These ranges are identical to those employed in 1995—1 to 5 percent for M2 and 2 to 6 percent for M3. The Committee also reaffirmed the 3 to 7 percent range for debt. Patterns of money growth and velocity have been erratic in recent years, but should the monetary aggregates at some point re-establish their previous trend relationships with nominal income, average growth near the center of these ranges should be consistent with the eventual achievement of price stability.

Determining whether further changes to the stance of monetary policy will be necessary in the months ahead to foster progress toward our goals will be a continuing challenge. In formulating monetary policy, while we have in mind a forecast of the most likely outcome, we must also evaluate the consequences of other possible developments. Thus, it is sometimes the case that we take out monetary policy "insurance" when we perceive an imbalance in the net costs or benefits of coming out on one side or the other of the most probable scenario. For example, in our most recent actions, we saw a decline in the federal funds rate as not increasing inflationary risks unacceptably, while addressing the downside risks to the most likely forecast. In assessing the costs and benefits of adjustments to the stance of policy, members of the Committee recognize that policy affects the economy and inflation with a lag and thus needs to be formulated with a focus on the future.

Over the past year, we have kept firmly in mind our goals of containing inflation in the near term and moving over time toward price stability, and they will continue to guide us in the period ahead.

Structural forces may be assisting us in this regard. Increases in producers' costs and in output prices proved to be a little lower last year than many had anticipated. While it is too soon to draw any definitive conclusions, this experience provides some tentative evidence that basic, ongoing changes in the structure of the economy may be helping to hold down price pressures. These changes stem from the introduction of new technologies into a wide variety of production processes throughout the economy. Successive generations of these new technologies are being quickly embodied in the nation's capital stock and older technologies are, at a somewhat slower pace, being phased out. As a consequence, the nation's capital stock is turning over at an increasingly rapid pace, not primarily because of physical deterioration but reflecting technological and economic obsolescence.

The more rapid advance of information and communications technology and the associated acceleration in the turnover of the capital stock are being mirrored in a brisk restructuring of firms. In line with their adoption of new organizational structures and technologies, many enterprises are finding that their needs for various forms of labor are evolving just as quickly. In some cases, the job skills that were adequate only five years ago are no longer as relevant. Partly for that reason, most corporate restructurings have involved a significant number of permanent dismissals.

The phenomenon of restructuring can be especially unfortunate for those workers directly caught up in the process. Many dedicated, long-term workers in all types of American businesses—including long-established, stable, and profitable firms—have been let go.

An important consequence of the layoffs and dismissals associated with restructuring activity is a significant and widely reported increase in the sense of job insecurity. Concern about employment has been manifested in unusually low levels of indicators of labor unrest. Work stoppages, for example, were at a fifty-year low last year. And contract negotiators for labor unions have sought to obtain greater job security for their members through very long-term labor contracts, including some with virtually unprecedented lengths of five or six years.

Of particular relevance to the inflation outlook, the sense of job insecurity is having a pronounced effect in damping labor costs. For example, the increase in the employment cost index for compensation in the private sector, which includes both wage and salary payments and benefit costs, slowed further in 1995,

to 2¾ percent, despite labor market conditions that, by historical standards, were fairly tight. With productivity also expanding, the increase in unit labor costs was even lower. In manufacturing, such costs have actually been falling in recent years. While the link between labor costs, which account for two-thirds of consolidated business sector costs, and prices is not rigid, these very limited increases in labor expenses nonetheless constitute a significant restraint on inflation.

In addition to its effect on labor costs, the more rapid pace of technological change is reducing business costs through other channels. Initially most important, the downsizing of products resulting from semiconductor technologies, together with the increasing proportion of national output accounted for by high-tech products, has reduced costs of transporting the average unit of GDP. Quite simply, small products can be moved more quickly and at lower cost.

More recently, dramatic advances in telecommunications technologies have lowered the costs of production for a variety of products by slashing further the information component of those costs. Increasingly, the physical distance between communications endpoints is becoming less relevant in determining the difficulty and cost of transporting information. Once fiber-optic and satellite technologies are in place, the added resource cost of another 200 or 2,000 miles is often quite trivial. As a consequence, the movement of inputs and outputs across geographic distance is progressively becoming a smaller component of overall business expenses, particularly as intellectual—and therefore immaterial—products become proportionately more important in the economy. This enables an average business firm to broaden markets and sales far beyond its original domicile. Accordingly, fixed costs are spread more widely. For the world market as a whole, the specialization of labor is enhanced to the benefit of standards of living of all market participants.

To be sure, advancing technology, with its profound implications for the nature of the economy, is nothing new, and the pace of improvement has never been even. But it is possible that we may be in the midst of a quickening of the process. It is possible that the rate at which earlier computer technologies are being applied to new production processes is still increasing. This would explain the recent decline in the growth of unit costs. Nonetheless, we have to be careful in projecting a further acceleration in the application of technology indefinitely into the future, as would be required for technological change to depress the rate of increase in unit business costs even more.

Similarly, suppressed wage cost growth as a consequence of job insecurity can be carried only so far. At some point in the future, the tradeoff of subdued wage growth for job security has to come to an end. While it is difficult to judge the time frame on such adjustments, the risks to cost and price inflation going forward are not entirely skewed to the downside, especially with the economy so recently operating at high levels of resource utilization.

In light of the quickened pace of technological change, the question arises whether the U.S. economy can expand more rapidly on an ongoing basis than the 2 to 2¼ percent range for measured GDP forecasted for 1996 by government agencies and most private forecasters without adding to inflationary pressures, which in turn would undermine growth. The Federal Reserve would certainly welcome faster growth—provided that it is sustainable.

The particular rate of maximum sustainable growth in an economy as complex and ever-changing as ours is difficult to pin down. Fortunately, the Federal Reserve does not need to have a firm judgment on such an estimate, for persistent deviations of actual growth from that of capacity potential will soon send signals that a policy adjustment is needed. Should the nation's true growth potential exceed actual growth, for example, the disparity and lessened strain would be signaled in shorter lead times on the delivery of materials, declining overtime, and ebbing inflationary pressures. Conversely, actual growth in excess of the economy's true potential would soon result in tightened markets and other distortions which, as history amply demonstrates, would propel the economy into recession. Consequently, we must be cautious in reaching conclusions that growth in productivity and hence of potential output has as yet risen to match the evident step-up in technological advance.

The hypothesis that advancing technology has enhanced productivity growth would be more persuasive if national data on productivity increases showed a distinct improvement. To a degree, the lack of any marked pickup may be a shortcoming of the statistics rather than a refutation of the hypothesis. Faulty data could be arising in part because business purchases are increasingly concentrated in items that are expensed but which market prices suggest should be capitalized. Growing disparities between book capital and its valuation in equity markets may in part reflect widening effects of this misclassification. If this problem is indeed growing, we may be underestimating the growth of our GDP and productivity.

This classification problem compounds other difficulties with measuring output in the increasingly important service sector. The output of services—and the productivity of labor in that sector—is particularly hard to measure. In part, the statisticians have simply thrown up their hands, gauging output in some service industries just in terms of labor input. By construction, such a procedure will miss improvements in productivity caused by other inputs. In manufacturing, where output is more tangible and therefore easier to assess, measured productivity has been rising briskly, suggesting that technological advances are indeed having some effect.

Nonetheless, there is still a nagging inconsistency: The evidence of significant restructurings and improvements in technology and real costs within business establishments does not seem to be fully reflected in our national productivity measurements. It is possible that some of the frenetic pace of business restructuring is mere wheel spinning—changing production inputs without increasing output—rather than real increases in productivity. One cause of the wheel spinning, if that is what it is, may be that it takes some time for firms to adapt in such a way that major new technology is translated into increased output.

In an intriguing parallel, electric motors in the late nineteenth century were well-known as a technology, but were initially integrated into production systems that were designed for steam-driven power plants. It wasn't until the gradual conversion of previously vertical factories into horizontal facilities, mainly in the 1920s, that firms were able to take full advantage of the synergies implicit in the electric dynamo, thus achieving dramatic productivity increases. Analogously, existing production systems today to some degree cannot be integrated easily with new information and communication technologies. Some existing equipment is not capable of control by computer, for example. Thus, it may be that the full advantage of even the current generation of information and communication equipment will be exploited over a span of quite a few years and only after a considerably updated stock of physical capital has been put in place.

While the Federal Reserve does not need to establish targets—and definitely not limits—for long-term growth, it is helpful in coming to shorter-run policy insights to have some judgments about the growth in potential GDP in the past and what it is likely to be in the future. Judgments of potential, quite naturally, are based on experience.

Through the four quarters of 1994, for example, real GDP, pressed by strong demand, rose 3½ percent. If that were the true rate of increase in the economy's long-run potential, then we would have expected no change in rates of resource utilization. Instead, industrial capacity utilization rose nearly 3 percentage points and the unemployment rate dropped a percentage point. Moreover, we began to see signs of strains on facilities; deliveries of materials slowed appreciably and factory overtime rose sharply. These signs of developing pressures on capacity suggest that the growth rate in economic potential in 1994 was below 3½ percent. In general, as we get close to presumed potential, we are required to step up our surveillance for inflationary pressures.

Estimates of potential growth necessarily recognize that expansion in the economy over time comes essentially from three factors—growth in population, increases in labor force participation, and gains in average labor productivity. Of these factors, the first two are determined basically by demographic and social factors and seem unlikely to change dramatically over the next few years. Thus, the source of any significant pickup of output growth would need to be a more rapid pace of productivity growth. Here, the uncertainty of the pace of conversion of rapid technological advance into productivity gains is crucial to the determination.

To be fully effective in achieving potential productivity improvements, technological innovations also require a considerable amount of human investment on the part of workers who have to deal with these devices on a day-to-day basis. On this score, we still may not have progressed very far. Many workers still possess only rudimentary skills in manipulating advanced information technology. In these circumstances, firms and employees alike need to recognize that obtaining the potential rewards of the new technologies in the years ahead will require a renewed commitment to effective education and training, especially on-the-job training. This is especially the case if we are to prevent the disruptions to lives and the nation's capacity to produce that arise from mismatches between jobs and workers. We need to improve the preparation for the job market our schools do, but even better schools are unlikely to be able to provide adequate skills to support a lifetime of work. Indeed, the need to ensure that our labor force has the ongoing education and training necessary to compete in an increasingly sophisticated world economy is a critical task for the years ahead.

Our nation faces many important and difficult challenges in economic policy. Nonetheless, we have made significant and fundamental gains in macroeconomic performance in recent years that enhance the prospects for maximum sustainable economic growth.Inflation, as measured by the consumer price index, has been gradually reduced from a peak of more than 13 percent in 1979 to 2½ percent last year. Lower rates of inflation have brought a variety of benefits to the economy, including lower long-term interest rates, a sense of greater economic stability, an improved environment for household and business planning, and more robust investment in capital expenditures. The years ahead should see further progress against inflation and the eventual achievement of price stability.

We have also made considerable progress on the fiscal front. Over the past ten years and especially since 1993, our elected political leaders, through sometimes prolonged and even painful negotiations, have been successful in reaching several agreements that have significantly narrowed the budget deficit. But more remains to be done. As I have emphasized many times, lower budget deficits are the surest and most direct way to increase national saving. Higher national saving would help to reduce real interest rates further, promoting more rapid accumulation of productive capital embodying recent technological advances. Agreement is widely shared that attaining a higher national saving rate quite soon is crucial, particularly in view of the anticipated shift in the nation's demographics in the first few decades of the next century.

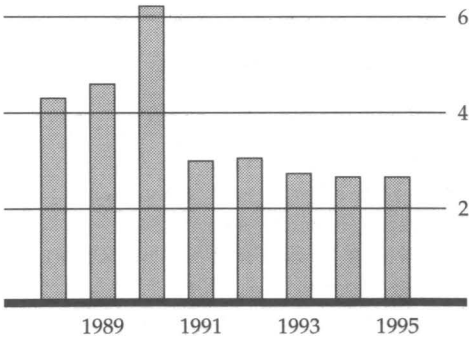
Lower inflation and reduced budget deficits will by no means solve all of the economic problems we face. But the achievement of price stability and federal budget balance or surplus will provide the best possible macroeconomic climate in which the nation can address other economic challenges.

Monetary Policy and the Economic Outlook

The economy performed well in 1995. Moderate economic growth kept the unemployment rate at a relatively low level, and inflation, as measured by the change in the consumer price index, was in a range of 3 percent or less for the fifth straight year, the first such occurrence in thirty years. This desirable combination of low inflation and low unemployment provided further substantiation of a fundamental point that the Board has made in past reports—namely, that there is no trade-off in the long run between the monetary policy goals of maximum employment and stable prices set in the Federal Reserve Act.

Change in Consumer Prices

Percent, Q4 to Q4

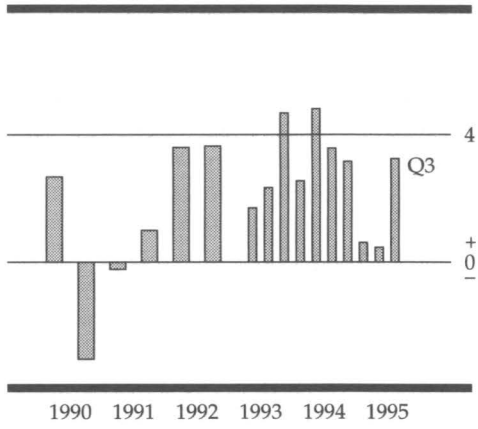


Note. Consumer price index for all urban consumers.

Indeed, it is by fostering price stability that a central bank can make its greatest contribution to the efficient operation and overall ability of the nation's economy to create jobs and advance living standards over time.

Change in Real GDP

Percent, annual rate

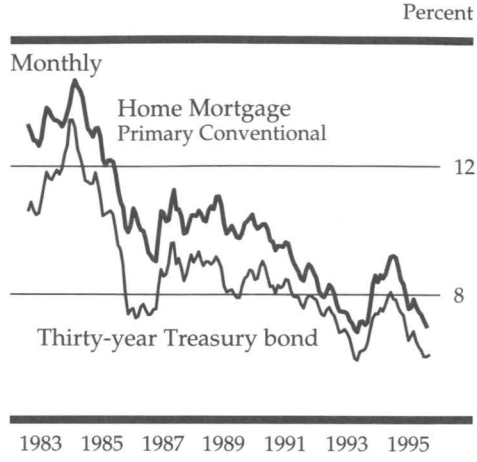


As economic prospects changed in 1995 and early 1996, the Federal Reserve found that promoting full employment and price stability required several adjustments in its policy settings. Last February, the economy still seemed to be pressing against its potential, and prices were tending to accelerate. To reduce the risk that inflation might mount, with the attendant threat to continued economic expansion, the Federal Open Market Committee raised the federal funds rate an additional ½ percentage point, to 6 percent. Inflation did, in fact, pick up in the first part of 1995,

but data released during the spring indicated that price pressures were receding, and the Committee reduced the federal funds rate ¼ percentage point at its July meeting. Through the remainder of the year, inflation was even more favorable than had been anticipated in July, and inflation expectations decreased. In addition, an apparent slowing of economic activity late in the year further reduced the potential for inflationary pressures going forward. To forestall an undue increase in real interest rates as inflation slowed, and to guard against the possibility of unnecessary slack developing in the economy, the Committee eased reserve conditions in December and again at the end of January 1996, reducing the federal funds rate by a total of ½ percentage point.

Monetary policy easings since mid-1995 contributed to declines in short-term market interest rates, which by mid-February were down 1 to 2 percentage points from the highs reached early last year. Intermediate- and long-term rates also moved sharply lower last year as the risks of rising inflation receded and as prospects for substantial progress in reducing the federal budget deficit seemed to improve. As of mid-February, these rates were 1¾ to 2¾ percentage points below their levels at the beginning of 1995. Helped by lower interest rates and favorable earnings, major equity price indexes rose 30 to 40 percent last year and have moved still higher in early 1996.

Long-Term Interest Rates



These financial developments reduced the cost to businesses of financing investment and to households of buying homes and consumer durables; households were also aided by substantial additions to financial wealth from rising bond and equity prices.

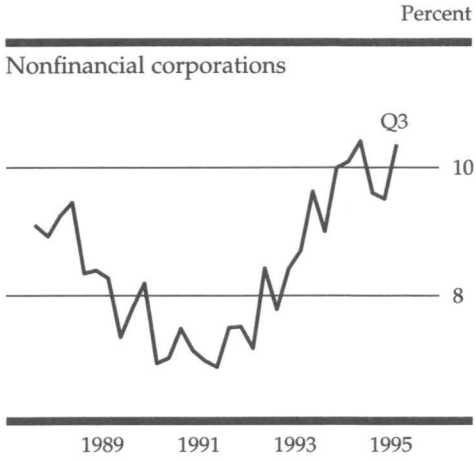
The foreign exchange value of the U.S. dollar, measured in terms of the currencies of the other G-10 countries, fell about 5 percent, on net, during 1995. The dollar appreciated substantially from the summer on and has advanced further on balance in 1996 but not enough to offset a sharp decline that took place in the first four months of 1995. Interest rates fell in most other foreign industrial countries, which also were experiencing slower economic growth, but by less than the decline in rates in the United States.

Early in 1995, the dollar also was pulled down by the reactions to the crisis in Mexico, but the negative influence on the dollar from this source appeared to lessen as Mexican financial markets stabilized over the balance of the year. Inflation rates in major industrial countries held fairly steady in 1995 at levels somewhat lower than those prevailing in this country; thus, depreciation of the dollar in real terms against other G-10 currencies was less than the depreciation in nominal terms. Against the currencies of a broader group of U.S. trading partners, the dollar's real depreciation in 1995 was even smaller.

Weighted Average Foreign Exchange Value of the U.S. Dollar

Note. Index of weighted foreign exchange value of U.S. dollar in terms of currencies of the other G-10 countries. Weights are based on 1972–76 global trade of each of the foreign countries.

Before-Tax Profit Share of GDP

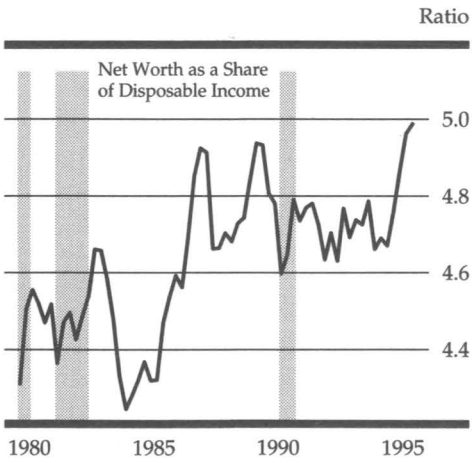


Note. Profits from domestic operations with inventory valuation and capital consumption adjustments, divided by gross domestic product of nonfinancial corporate sector.

Borrowing and spending in the United States was facilitated not only by lower interest rates but also by favorable supply conditions in credit markets. Spreads between interest rates on securities issued by private firms and those issued by the Treasury generally remained narrow, and banks continued to ease terms and qualifying standards on loans to businesses and households through most of the year. Total debt of domestic nonfinancial sectors grew slightly more than 5 percent last year, just above the midpoint of the Committee's 3 percent to 7 percent monitoring range. Rapid growth of business spending on inventories and fixed capital early in the year boosted the credit demands of firms, despite strong corporate profits.

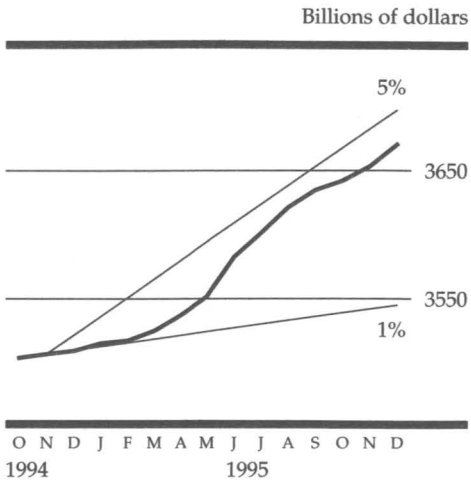
Borrowing was also lifted by the financing of heavy net retirements of equity shares in connection with mergers and share repurchase programs. Growth of household debt slowed a bit but remained brisk; consumer credit continued to grow quite rapidly. Federal debt growth was relatively modest for a second year, influenced by a lower deficit and constraints on normal seasonal borrowing at year-end owing to the federal debt ceiling. Outstanding state and local government debt ran off more rapidly than in 1994.

Household Financial Condition



Commercial banks and thrift institutions again financed a large portion of the borrowing last year; their share of total outstanding debt of nonfederal sectors edged up in 1994 and 1995 after declining for more than fifteen years. The growth in depository credit was funded primarily with deposits,

M2: Actual Range and Actual Level



boosting the expansion of the broad monetary aggregates. M3 grew 6 percent, at the upper end of its 2 percent to 6 percent annual range established by the Committee at midyear. Depositories relied heavily on large-denomination time deposits for funding, but retail deposits also showed gains as declining market interest rates made these deposits more attractive to retail customers. M2 advanced 4¼ percent, putting it in the upper portion of its 1 percent to 5 percent annual range. The expansion of M2 was the largest in six years, and its velocity was unchanged after increasing during the previous three years. Nonetheless, growth of the aggregate was erratic through the year, and the stability of its relationship to nominal spending remains in doubt. M1 declined last year for the first time since the beginning of the official series in 1959.

An increasing number of banks introduced retail sweep accounts, which shift money from interest-bearing checkable accounts to savings accounts in order to reduce banks' reserve requirements. Without these shifts, M1 would have risen in 1995, although slowly.

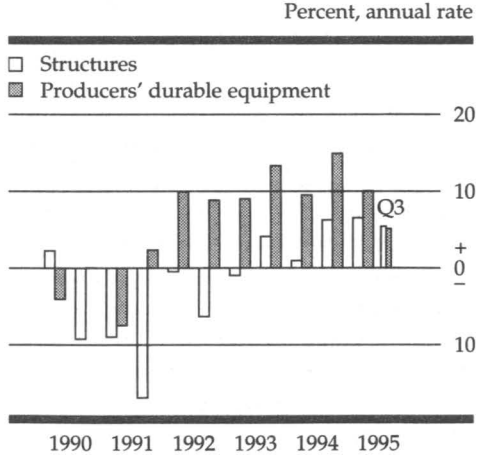
Economic Projections for 1996

The relatively small amount of information that is available for 1996 indicates that the economy has started off slowly early this year, but fundamental conditions appear to be more encouraging than recent data might seem to suggest. Bad weather in a number of regions and the partial shutdown of the federal government have been disruptive to the economy this winter. These influences seem likely to leave only temporary imprints on spending and production, creating volatility in incoming data over the near term while having little effect on underlying trends.

The economy also has been slowed by production adjustments in some industries in which efforts are being made to bring stocks into better alignment with sales. Inventory accumulation apparently slowed in the fourth quarter, and with financial conditions remaining broadly conducive to growth of private final sales, inventory problems of a degree that might prompt a sustained period of widespread production adjustments do not seem likely.

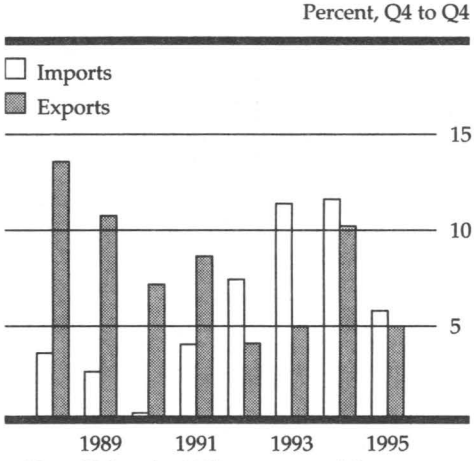
In the household sector, the accumulation of financial wealth brought on by the rise in the stock market has provided the wherewithal for increases in consumption greater than would otherwise have been expected—countering the potential negative influences of more burdensome levels of consumer debt. At the same time, reductions in mortgage interest rates have put the cost of financing a house within reach of a greater number of families and made it possible for a significant number of households to ease their debt-service burdens by refinancing their homes at lower rates. In the business sector, reductions in the cost of financing investment in new capital are providing some offset to the slowing tendencies that normally accompany a cyclical moderation in the growth of aggregate output.

Change in Real Business Fixed Investment



In addition, business investment in high-tech equipment likely will continue to be boosted not only by the ready availability of finance but also by technological upgrades and ongoing steep declines in the effective price of real computing power.

Change in Real Imports and Exports of Goods and Services



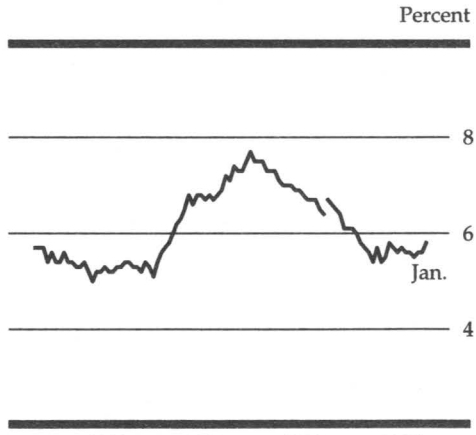
Note. Values for 1995 are measured from 1994: Q4 to 1995: Q3 at an annual rate.

In the U.S. external sector, growth of exports strengthened after some sluggishness early in 1995. Expansion of income abroad seems likely to pick up this year, although the prospects still are subject to some downside risk.

Imports, meanwhile, have slowed from the very rapid pace seen earlier in the expansion. On net, the underlying trends in exports and imports of goods and services appear to be essentially canceling out in terms of their combined contribution to growth of U.S. real GDP.

Against the backdrop of these developments, members of the Board of Governors and the Reserve Bank Presidents, all of whom participate in the deliberations of the Federal Open Market Committee, anticipate that the U.S. economy will grow moderately, with little change in underlying inflation trends. The central tendency of the participants' forecasts of real GDP growth ranges from 2 percent to 2¼ percent, measured as the cumulative change in output from the final quarter of 1995 to the final quarter of 1996. The rise in activity is expected to be accompanied by further expansion of job opportunities and little change, on net, in the civilian unemployment rate over the four quarters of 1996.

Civilian Unemployement Rate



Note. The break in data at January 1994 marks the introduction of a redesigned survey; data from that point on are not directly comparable with the data of earlier periods.

Economic Projections for 1996

Percent

Indicator		Federal Reserve Governors and Reserve Bank Presidents		Administration
		Range	Central Tendency	
Change, fourth quarter to fourth quarter:[1]	Nominal GDP	4–5	4¼–4¾	5.1
	Real GDP[2]	1½–2½	2–2¼	2.2
	Consumer price index[3]	2½–3	2¾–3	3.1
Average level in the fourth quarter:	Civilian unemployment rate	5½–6	5½–5¾	5.7[4]

1. Change from average for fourth quarter of 1995 to average for fourth quarter of 1996.
2. Chain-weighted.
3. All urban consumers.
4. Annual average.

The central tendency of the unemployment rate forecasts for the fourth quarter of 1996 is a range of 5½ percent to 5¾ percent, compared with an average of 5.6 percent in the final quarter of 1995. The Committee's forecasts of economic growth and unemployment are quite similar to those of the Administration.

The central tendency of the Governors' and Bank Presidents' forecasts of the rise in the consumer price index over the four quarters of 1996 is a range of 2¾ percent to 3 percent, a shade to the high side of the actual outcome of 1995. At this early point in 1996, with grain stocks exceptionally tight, there is some risk that food price increases at retail could be larger than those of recent years, especially if crop production should remain subpar again this year; and, even though recent upward pressures on energy prices should diminish with the return of normal weather, another year of declining prices cannot be taken as a given. Nonetheless, the experience with inflation at high levels of resource utilization was favorable in 1995, and with businesses still tightly focused on cost control and efficiency gain, broad tendencies toward increased rates of price increase are not anticipated. The Administration forecast of inflation is higher than the forecasts of the Federal Reserve officials, but the difference is not significant, given the uncertainties of forecasting.

Price increases like those being forecast for the coming year would leave inflation no higher than it was in the first year or so of the current economic expansion, with the rate of increase holding appreciably below the average rate seen during the expansion of the 1980s. Although the Federal Reserve's long-run goal of restoring price stability has not yet been achieved, the capping of inflation and its diminution over recent business cycles is a clear indication of the substantial progress that has been made to date.

Money and Debt Ranges for 1996

The Committee's intention to make further progress over time toward price stability formed the basis for the selection of the growth ranges for the monetary aggregates in 1996. In reaffirming the ranges that were adopted on a provisional basis in July, the Committee noted that it viewed them as benchmarks for what would be expected under conditions of reasonable price stability and historical velocity behavior. The Committee set the range for M2 at 1 percent to 5 percent and the range for M3 at 2 percent to 6 percent.

Given its expectations for inflation in 1996, the Committee anticipates that nominal GDP will grow somewhat faster this year than would be the case if the economy already were at price stability.

Ranges for Growth of Monetary and Debt Aggregates

Percent

Aggregate	1994	1995	1996
M2	1–5	1–5	1–5
M3	0–4	2–6[1]	2–6
Debt[2]	4–8	3–7	3–7

Note. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.

1. Revised at July 1995 FOMC meeting.
2. Monitoring range for debt of domestic nonfinancial sectors.

If velocities of the aggregates were to exhibit roughly normal behavior this year and nominal income were to expand as anticipated by the Committee, M2 and M3 might grow near the upper ends of their ranges. In assessing the possible outcomes, the Committee noted that considerable uncertainty remains about the usefulness of the monetary aggregates in guiding the pursuit of its macroeconomic objectives.Although the monetary aggregates have been behaving more in line with historical patterns than was the case earlier in the decade, the effects of financial innovation and deregulation over the years have raised questions about the stability of the relationships between the aggregates and nominal GDP that have yet to be resolved.

The Committee also reaffirmed the 3 percent to 7 percent growth range for debt. Although there are indications that lenders may no longer be easing terms and conditions for granting credit to businesses and households, the Committee anticipated that credit supplies would remain ample and that debt would grow at about the same pace as nominal GDP. Such increases would be consistent with containing inflation and promoting sustainable growth.

Growth of Money and Debt

Percent

Period		M1	M2	M3	Domestic Nonfinancial Debt
Year[1]	1980	7.5	8.7	9.6	9.5
	1981	5.4 (2.5)[2]	9.0	12.4	10.2
	1982	8.8	8.8	9.7	9.8
	1983	10.3	11.8	9.5	11.9
	1984	5.4	8.1	10.8	14.6
	1985	12.0	8.6	7.7	14.3
	1986	15.5	9.2	9.0	13.3
	1987	6.3	4.2	5.9	9.9
	1988	4.3	5.7	6.3	9.0
	1989	.5	5.2	4.0	7.8
	1990	4.2	4.1	1.8	6.8
	1991	7.9	3.1	1.2	4.6
	1992	14.3	1.8	.6	4.7
	1993	10.5	1.4	1.0	5.2
	1994	2.4	.6	1.6	5.2
	1995	–1.8	4.2	6.1	5.3
1994 Quarter *(annual rate)*[3]	Q1	–.1	1.4	4.8	5.3
	Q2	–.5	4.3	6.7	7.0
	Q3	–1.5	7.0	8.0	4.6
	Q4	–5.1	4.0	4.4	3.9

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.

2. Adjusted for shifts to NOW accounts in 1981.

3. From average for preceding quarter to average for quarter indicated.

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