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2000 *Monetary Policy Objectives*

A Summary Report of the Federal Reserve Board

February 17, 2000



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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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Testimony of Alan Greenspan Chairman, Federal Reserve Board

I appreciate this opportunity to present the Federal Reserve's semiannual report on the economy and monetary policy.

There is little evidence that the American economy, which grew more than 4 percent in 1999 and surged forward at an even faster pace in the second half of the year, is slowing appreciably. At the same time, inflation has remained largely contained. An increase in the overall rate of inflation in 1999 was mainly a result of higher energy prices. Importantly, unit labor costs actually declined in the second half of the year. Indeed, still-preliminary data indicate that total unit cost increases last year remained extraordinarily low, even as the business expansion approached a record nine years. Domestic operating profit margins, after sagging for eighteen months, apparently turned up again in the fourth quarter, and profit expectations for major corporations for the first quarter have been undergoing upward revisions since the beginning of the year—scarcely an indication of imminent economic weakness.

The Economic Forces at Work

Underlying this performance, unprecedented in my half-century of observing the American economy, is a continuing acceleration in productivity. Nonfarm business output per work-

hour increased 3 $\frac{3}{4}$ percent during the past year—likely more than 4 percent when measured by nonfarm business income. Security analysts' projections of long-term earnings, an indicator of expectations of company productivity, continued to be revised upward in January, extending a string of upward revisions that began in early 1995. One result of this remarkable economic performance has been a pronounced increase in living standards for the majority of Americans. Another has been a labor market that has provided job opportunities for large numbers of people previously struggling to get on the first rung of a ladder leading to training, skills, and permanent employment.

Yet those profoundly beneficial forces driving the American economy to competitive excellence are also engendering a set of imbalances that, unless contained, threaten our continuing prosperity. Accelerating productivity entails a matching acceleration in the potential output of goods and services and a corresponding rise in real incomes available to purchase the new output. The problem is that the pickup in productivity tends to create even greater increases in aggregate demand than in potential aggregate supply. This occurs principally because a rise in structural productivity growth has its counterpart in higher expectations for long-term corporate earnings. This, in turn, not only spurs business investment but also increases stock prices and the market value of assets held by households, creating addi-

tional purchasing power for which no additional goods or services have yet been produced.

Historical evidence suggests that perhaps three to four cents out of every additional dollar of stock market wealth eventually is reflected in increased consumer purchases. The sharp rise in the amount of consumer outlays relative to disposable incomes in recent years, and the corresponding fall in the saving rate, has been consistent with this so-called wealth effect on household purchases. Moreover, higher stock prices, by lowering the cost of equity capital, have helped to support the boom in capital spending.

Outlays prompted by capital gains in excess of increases in income, as best we can judge, have added about 1 percentage point to annual growth of gross domestic purchases, on average, over the past five years. The additional growth in spending of recent years that has accompanied these wealth gains as well as other supporting influences on the economy appears to have been met in about equal measure from increased net imports and from goods and services produced by the net increase in newly hired workers over and above the normal growth of the work force, including a substantial net inflow of workers from abroad.

But these safety valves that have been supplying goods and services to meet the recent increments to purchasing power largely generated by capital gains cannot be expected to absorb an excess of demand over supply indefinitely. First, growing net imports and a

widening current account deficit require ever larger portfolio and direct foreign investments in the United States, an outcome that cannot continue without limit.

Imbalances in the labor markets perhaps may have even more serious implications for inflation pressures. While the pool of officially unemployed and those otherwise willing to work may continue to shrink, as it has persistently over the past seven years, there is an effective limit to new hiring, unless immigration is uncapped. At some point in the continuous reduction in the number of available workers willing to take jobs, short of the repeal of the law of supply and demand, wage increases must rise above even impressive gains in productivity. This would intensify inflationary pressures or squeeze profit margins, with either outcome capable of bringing our growing prosperity to an end.

As would be expected, imbalances between demand and potential supply in markets for goods and services are being mirrored in the financial markets by an excess in the demand for funds. As a consequence, market interest rates are already moving in the direction of containing the excess of demand in financial markets and therefore in product markets as well. For example, BBB corporate bond rates adjusted for inflation expectations have risen by more than 1 percentage point during the past two years. However, to date, rising business earnings expectations and declining compensation for risk have more than offset the effects of this

increase, propelling equity prices and the wealth effect higher. Should this process continue, however, with the assistance of a monetary policy vigilant against emerging macroeconomic imbalances, real long-term rates will at some point be high enough to finally balance demand with supply at the economy's potential in both the financial and product markets. Other things equal, this condition will involve equity discount factors high enough to bring the rise in asset values into line with that of household incomes, thereby stemming the impetus to consumption relative to income that has come from rising wealth. This does not necessarily imply a decline in asset values—although that, of course, can happen at any time for any number of reasons—but rather that these values will increase no faster than household incomes.

Because there are limits to the amount of goods and services that can be supplied from increasing net imports and by drawing on a limited pool of persons willing to work, it necessarily follows that consumption cannot keep rising faster than income. Moreover, outsized increases in wealth cannot persist indefinitely either. For so long as the levels of consumption and investment are sensitive to asset values, equity values increasing at a pace faster than income, other things equal, will induce a rise in overall demand in excess of potential supply. But that situation cannot persist without limit because the supply safety valves are themselves limited.

With foreign economies strengthening and labor markets already tight, how the current wealth effect is finally contained will determine whether the extraordinary expansion that it has helped foster can slow to a sustainable pace, without destabilizing the economy in the process.

Technological Change Continues Apace

On a broader front, there are few signs to date of slowing in the pace of innovation and the spread of our newer technologies that, as I have indicated in previous testimonies, have been at the root of our extraordinary productivity improvement. Indeed, some analysts conjecture that we still may be in the earlier stages of the rapid adoption of new technologies and not yet in sight of the stage when this wave of innovation will crest. With so few examples in our history, there is very little basis for determining the particular stage of development through which we are currently passing.

Without doubt, the synergies of the microprocessor, laser, fiber-optic glass, and satellite technologies have brought quantum advances in information availability. These advances, in turn, have dramatically decreased business operational uncertainties and risk premiums and, thereby, have engendered major cost reductions and productivity advances. There seems little question that further major advances lie ahead. What is uncertain is the future pace of the application of these innovations,

because it is this pace that governs the rate of change in productivity and economic potential.

Monetary policy, of course, did not produce the intellectual insights behind the technological advances that have been responsible for the recent phenomenal reshaping of our economic landscape. It has, however, been instrumental, we trust, in establishing a stable financial and economic environment with low inflation that is conducive to the investments that have exploited these innovative technologies.

Federal budget policy has also played a pivotal role. The emergence of surpluses in the unified budget and of the associated increase in government saving over the past few years has been exceptionally important to the balance of the expansion, because the surpluses have been absorbing a portion of the potential excess of demand over sustainable supply associated partly with the wealth effect. Moreover, because the surpluses are augmenting the pool of domestic saving, they have held interest rates below the levels that otherwise would have been needed to achieve financial and economic balance during this period of exceptional economic growth. They have, in effect, helped to finance and sustain the productive private investment that has been key to capturing the benefits of the newer technologies that, in turn, have boosted the long-term growth potential of the U.S. economy.

The recent good news on the budget suggests that our longer-run prospects

for continuing this beneficial process of recycling savings from the public to the private sectors have improved greatly in recent years. Nonetheless, budget outlays are expected to come under mounting pressure as the baby boom generation moves into retirement, a process that gets under way a decade from now. Maintaining the surpluses and using them to repay debt over coming years will continue to be an important way the federal government can encourage productivity-enhancing investment and rising standards of living. Thus, we cannot afford to be lulled into letting down our guard on budgetary matters, an issue to which I shall return later in this testimony.

The Economic Outlook

Although the outlook is clouded by a number of uncertainties, the central tendencies of the projections of the Board members and Reserve Bank presidents imply continued good economic performance in the United States. Most of them expect economic growth to slow somewhat this year, easing into the $3\frac{1}{2}$ to $3\frac{3}{4}$ percent area. The unemployment rate would remain in the neighborhood of 4 to $4\frac{1}{4}$ percent. The rate of inflation for total personal consumption expenditures is expected to be $1\frac{3}{4}$ to 2 percent, at or a bit below the rate in 1999, which was elevated by rising energy prices.

In preparing these forecasts, the Federal Open Market Committee members had to consider several of the crucial

demand- and supply-side forces I referred to earlier. Continued favorable developments in labor productivity are anticipated both to raise the economy's capacity to produce and, through its supporting effects on real incomes and asset values, to boost private domestic demand. When productivity-driven wealth increases were spurring demand a few years ago, the effects on resource utilization and inflation pressures were offset in part by the effects of weakening foreign economies and a rising foreign exchange value of the dollar, which depressed exports and encouraged imports. Last year, with the welcome recovery of foreign economies and with the leveling out of the dollar, these factors holding down demand and prices in the United States started to unwind. Strong growth in foreign economic activity is expected to continue this year, and, other things equal, the effect of the previous appreciation of the dollar should wane, augmenting demand on U.S. resources and lessening one source of downward pressure on our prices.

As a consequence, the necessary alignment of the growth of aggregate demand with the growth of potential aggregate supply may well depend on restraint on domestic demand, which continues to be buoyed by the lagged effects of increases in stock market valuations. Accordingly, the appreciable increases in both nominal and real intermediate- and long-term interest rates over the last two years should act as a needed restraining influence in

the period ahead. However, to date, interest-sensitive spending has remained robust, and the FOMC will have to stay alert for signs that real interest rates have not yet risen enough to bring the growth of demand into line with that of potential supply, even should the acceleration of productivity continue.

Achieving that alignment seems more pressing today than it did earlier, before the effects of imbalances began to cumulate, lessening the depth of our various buffers against inflationary pressures. Labor markets, for example, have tightened in recent years as demand has persistently outstripped even accelerating potential supply. As I have previously noted, we cannot be sure in an environment with so little historical precedent what degree of labor market tautness could begin to push unit costs and prices up more rapidly. We know, however, that there is a limit, and we can be sure that the smaller the pool of people without jobs willing to take them, the closer we are to that limit. As the FOMC indicated after its last meeting, the risks still seem to be weighted on the side of building inflation pressures.

A central bank can best contribute to economic growth and rising standards of living by fostering a financial environment that promotes overall balance in the economy and price stability. Maintaining an environment of effective price stability is essential, because the experience in the United States and abroad has underscored that low and stable inflation is a prerequisite for

healthy, balanced, economic expansion. Sustained expansion and price stability provide a backdrop against which workers and businesses can respond to signals from the marketplace in ways that make most efficient use of the evolving technologies.

Federal Budget Policy Issues

Before closing, I should like to revisit some issues of federal budget policy that I have addressed in previous congressional testimony. Some modest erosion in fiscal discipline resulted last year through the use of the “emergency” spending initiatives and some “creative accounting.” Although somewhat disappointing, that erosion was small relative to the influence of the wise choice of the Administration and the Congress to allow the bulk of the unified budget surpluses projected for the next several years to build and retire debt to the public. The idea that we should stop borrowing from the social security trust fund to finance other outlays has gained surprising—and welcome—traction, and it establishes, in effect, a new budgetary framework that is centered on the on-budget surplus and how it should be used.

This new framework is useful because it offers a clear objective that should strengthen budgetary discipline. It moves the budget process closer to accrual accounting, the private-sector norm, and—I would hope—the ultimate objective of federal budget accounting.

The new budget projections from the Congressional Budget Office and the Administration generally look reasonable. But, as many analysts have stressed, these estimates represent a midrange of possible outcomes for the economy and the budget, and actual budgetary results could deviate quite significantly from current expectations. Some of the uncertainty centers on the likelihood that the recent spectacular growth of labor productivity will persist over the years ahead. Like many private forecasters, the CBO and the Office of Management and Budget assume that productivity growth will drop back somewhat from the recent stepped-up pace. But a distinct possibility, as I pointed out earlier, is that the development and diffusion of new technologies in the current wave of innovation may still be at a relatively early stage and that the scope for further acceleration of productivity is thus greater than is embodied in these budget projections. If so, the outlook for budget surpluses would be even brighter than is now anticipated.

But there are significant downside risks to the budget outlook as well. One is our limited knowledge of the forces driving the surge in tax revenues in recent years. Of course, a good part of that surge is due to the extraordinary rise in the market value of assets which, as I noted earlier, cannot be sustained at the pace of recent years. But that is not the entire story. These relationships are complex, and until we have detailed tabulations compiled from actual tax returns, we shall not

really know why individual tax revenues, relative to income, have been even higher than would have been predicted from rising asset values and bracket creep. Thus, we cannot rule out the possibility that this so-called “tax surprise,” which has figured so prominently in the improved budget picture of recent years, will dissipate or reverse. If this were to happen, the projected surpluses, even with current economic assumptions, would shrink appreciably and perhaps disappear. Such an outcome would be especially likely if adverse developments occurred in other parts of the budget as well—for example, if the recent slowdown in health care spending were to be followed by a sharper pickup than is assumed in current budget projections.

Another consideration that argues for letting the unified surpluses build is that the budget is still significantly short of balance when measured on an accrual basis. If social security, for example, were measured on such a basis, counting benefits when they are earned by workers rather than when they are paid out, that program would have shown a substantial deficit last year. The deficit would have been large enough to push the total federal budget into the red, and an accrual-based budget measure could conceivably record noticeable deficits over the next few years, rather than the surpluses now indicated by the official projections for either the total unified budget or the on-budget accounts. Such accruals take account of still growing contingent

liabilities that, under most reasonable sets of actuarial assumptions, currently amount to many trillions of dollars for social security benefits alone.

Even if accrual accounting is set aside, it might still be prudent to eschew new longer-term, potentially irreversible commitments until we are assured that the on-budget surplus projections are less conjectural than they are, of necessity, today.

Allowing surpluses to reduce the debt to the public, rather than for all practical purposes irrevocably committing to their disposition in advance, can be viewed as a holding action pending the clarification of the true underlying budget outcomes of the next few years. Debt repaid can very readily be reborrowed to fund delayed initiatives.

More fundamentally, the growth potential of our economy under current circumstances is best served, in my judgment, by allowing the unified budget surpluses presently in train to materialize and thereby reduce Treasury debt held by the public.

Yet I recognize that growing budget surpluses may be politically infeasible to defend. If this proves to be the case, as I have also testified previously, the likelihood of maintaining a still satisfactory overall budget position over the longer run is greater, I believe, if surpluses are used to lower tax rates rather than to embark on new spending programs. History illustrates the difficulties of keeping spending in check, especially in programs that are open-ended commitments, which too often have led to larger outlays than initially envi-

sioned. Decisions to reduce taxes, however, are more likely to be contained by the need to maintain an adequate revenue base to finance necessary government services. Moreover, especially if designed to lower marginal rates, tax reductions can offer favorable incentives for economic performance.

Conclusion

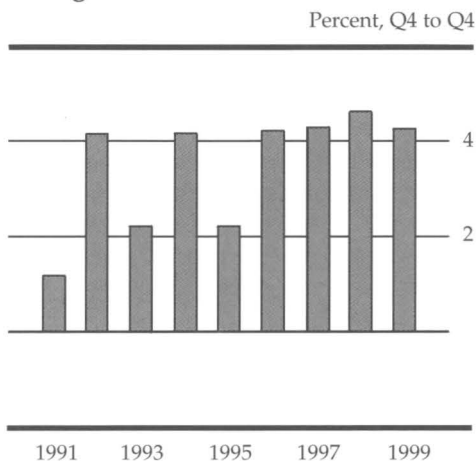
As the U.S. economy enters a new century as well as a new year, the time is opportune to reflect on the basic characteristics of our economic system that have brought about our success in recent years. Competitive and open markets, the rule of law, fiscal disci-

pline, and a culture of enterprise and entrepreneurship should continue to undergird rapid innovation and enhanced productivity that in turn should foster a sustained further rise in living standards. It would be imprudent, however, to presume that the business cycle has been purged from market economies so long as human expectations are subject to bouts of euphoria and disillusionment. We can only anticipate that we will readily take such diversions in stride and trust that beneficent fundamentals will provide the framework for continued economic progress well into the new millennium.

Monetary Policy and the Economic Outlook

The U.S. economy posted another exceptional performance in 1999. The ongoing expansion appears to have maintained strength into early 2000 as it set a record for longevity, and—aside from the direct effects of higher crude oil prices—inflation has remained subdued, in marked contrast to the typical experience during previous expansions. The past year brought additional evidence that productivity growth has improved substantially since the mid-1990s, boosting living standards while helping to hold down increases in costs and prices despite very tight labor markets.

Change in Real GDP



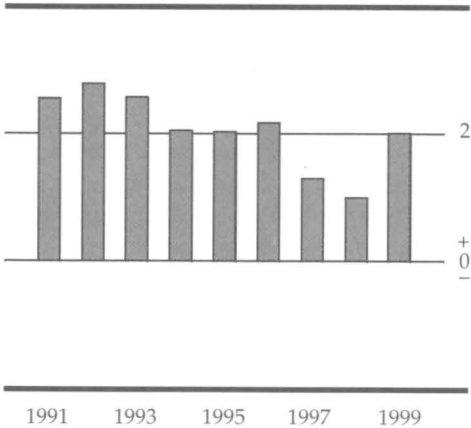
The Federal Open Market Committee's pursuit of financial conditions consistent with sustained expansion and low inflation has required some adjustments to the settings of monetary policy instruments over the past two

years. In late 1998, to cushion the U.S. economy from the effects of disruptions in world financial markets and to ameliorate some of the resulting strains, money market conditions were eased. By the middle of last year, however, with financial markets resuming normal functioning, foreign economies recovering, and domestic demand continuing to outpace increases in productive potential, the Committee began to reverse that easing.

As the year progressed, foreign economies, in general, recovered more quickly and displayed greater vigor than had seemed likely at the start of the year. Domestically, the rapid productivity growth raised expectations of future incomes and profits and thereby helped keep spending moving up at a faster clip than current productive capacity. Meanwhile, prices of most internationally traded materials rebounded from their earlier declines; this turnaround, together with a flattening of the exchange value of the dollar after its earlier appreciation, translated into an easing of downward pressure on the prices of imports in general. Core inflation measures generally remained low, but with the labor market at its tightest in three decades and becoming tighter, the risk that pressures on costs and prices would eventually emerge mounted over the course of the year. To maintain the low-inflation environment that has been so important to the sustained health of the current expansion, the FOMC ultimately implemented four quarter-point increases in the intended federal funds

Change in PCE Chain-type Price Index

Percent, Q4 to Q4



rate, the most recent of which came at the beginning of this month. In total, the federal funds rate has been raised 1 percentage point, although, at $5\frac{3}{4}$ percent, it stands only $\frac{1}{4}$ point above its level just before the autumn-1998 financial market turmoil. At its most recent meeting, the FOMC indicated that risks appear to remain on the side of heightened inflation pressures, so it will need to remain especially attentive to developments in this regard.

Monetary Policy, Financial Markets, and the Economy over 1999 and Early 2000

The first quarter of 1999 saw a further unwinding of the heightened levels of perceived risk and risk aversion that had afflicted financial markets in the autumn of 1998; investors became much more willing to advance funds,

securities issuance picked up, and risk spreads fell further—though not back to the unusually low levels of the first half of 1998. At the same time, domestic demand remained quite strong, and foreign economies showed signs of rebounding. The FOMC concluded at its February and March meetings that, if these trends were to persist, the risks of the eventual emergence of somewhat greater inflation pressures would increase, and it noted that a case could be made for unwinding part of the easing actions of the preceding fall. However, the Committee hesitated to adjust policy before having greater assurance that the recoveries in domestic financial markets and foreign economies were on firm footing.

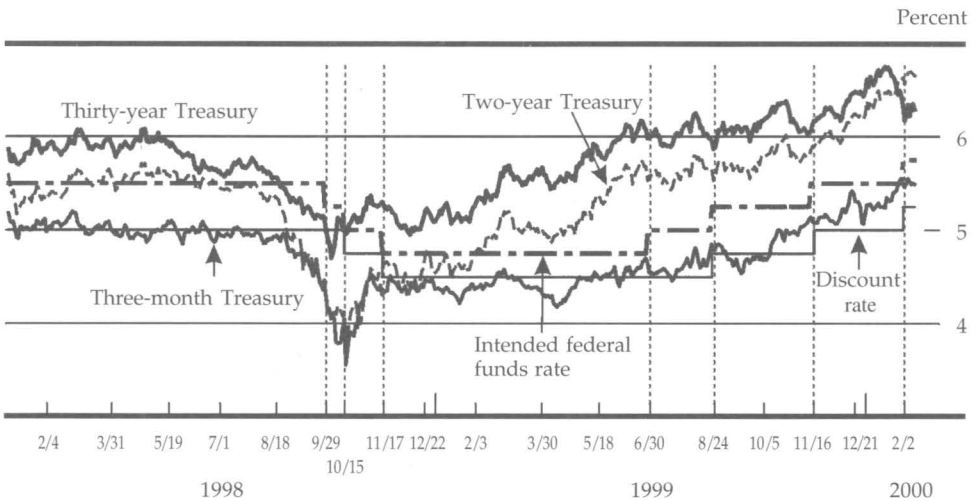
By the May meeting, these recoveries were solidifying, and the pace of domestic spending appeared to be outstripping the growth of the economy's potential, even allowing for an appreciable acceleration in productivity. The Committee still expected some slowing in the expansion of aggregate demand, but the timing and extent of any moderation remained uncertain. Against this backdrop, the FOMC maintained an unchanged policy stance but announced immediately after the meeting that it had chosen a directive tilted toward the possibility of a firming of rates. This announcement implemented the disclosure policy adopted in December 1998, whereby major shifts in the Committee's views about the balance of risks or the likely direction of future policy would be made public immedi-

ately. Members expected that, by making the FOMC's concerns public earlier, such announcements would encourage financial market reactions to subsequent information that would help stabilize the economy. In practice, however, those reactions seemed to be exaggerated and to focus even more than usual on possible near-term Committee action.

Over subsequent weeks, economic activity continued to expand vigorously, labor markets remained very tight, and oil and other commodity prices rose further. In this environment, the FOMC saw an updrift in inflation as a significant risk in the absence of some policy firming, and at the June meeting it raised the intended level

of the federal funds rate $\frac{1}{4}$ percentage point. The Committee also announced a symmetric directive, noting that the marked degree of uncertainty about the extent and timing of prospective inflationary pressures meant that further firming of policy might not be undertaken in the near term, but that the Committee would need to be especially alert to emerging inflation pressures. Markets rallied on the symmetric-directive announcement, and the strength of this response together with market commentary suggested uncertainty about the interpretation of the language used to characterize possible future developments and about the time period to which the directive applied.

Selected Interest Rates



Note. The data are daily. Vertical lines indicate the days on which the Federal Reserve announced a monetary policy action. The dates on the horizontal axis are those on which either the FOMC

held a scheduled meeting or a policy action was announced. Last observations are for February 11, 2000.

In the period between the June and August meetings, the ongoing strength of domestic demand and further expansion abroad suggested that at least part of the remaining easing put in place the previous fall to deal with financial market stresses was no longer needed. Consequently, at the August meeting the FOMC raised the intended level of the federal funds rate a further $\frac{1}{4}$ percentage point, to $5\frac{1}{4}$ percent. The Committee agreed that this action, along with that taken in June, would substantially reduce inflation risks and again announced a symmetric directive. In a related action, the Board of Governors approved an increase in the discount rate to $4\frac{3}{4}$ percent. At this meeting the Committee also established a working group to assess the FOMC's approach to disclosing its view about prospective developments and to propose procedural modifications.

At its August meeting, the FOMC took a number of actions that were aimed at enhancing the ability of the Manager of the System Open Market Account to counter potential liquidity strains in the period around the century date change and that would also help ensure the effective implementation of the Committee's monetary policy objectives. Although members believed that efforts to prepare computer systems for the century date change had made the probability of significant disruptions quite small, some aversion to Y2K risk exposure was already evident in the markets, and the costs that might stem from a

dysfunctional financing market at year-end were deemed to be unacceptably high. The FOMC agreed to authorize, temporarily, (1) a widening of the pool of collateral that could be accepted in System open market transactions, (2) the use of reverse repurchase agreement accounting in addition to the currently available matched sale-purchase transactions to absorb reserves temporarily, and (3) the auction of options on repurchase agreements, reverse repurchase agreements, and matched sale-purchase transactions that could be exercised in the period around year-end. The Committee also authorized a permanent extension of the maximum maturity on regular repurchase and matched sale-purchase transactions from sixty to ninety days.

The broader range of collateral approved for repurchase transactions—mainly pass-through mortgage securities of government-sponsored enterprises and STRIP securities of the U.S. Treasury—would facilitate the Manager's task of addressing what could be very large needs to supply reserves in the succeeding months, primarily in response to rapid increases in the demand for currency, at a time of potentially heightened demand in various markets for U.S. government securities. The standby financing facility, authorizing the Federal Reserve Bank of New York to auction the above-mentioned options to the government securities dealers that are regular counterparties in the System's open market operations, would encourage marketmaking and the maintenance of

liquid financing markets essential to effective open market operations. The standby facility was also viewed as a useful complement to the special liquidity facility, which was to provide sound depository institutions with unrestricted access to the discount window, at a penalty rate, between October 1999 and April 2000. Finally, the decision to extend the maximum maturity on repurchase and matched sale-purchase transactions was intended to bring the terms of such transactions into conformance with market practice and to enhance the Manager's ability over the following months to implement the unusually large reserve operations expected to be required around the turn of the year.

Incoming information during the period leading up to the FOMC's October meeting suggested that the growth of domestic economic activity had picked up from the second quarter's pace, and foreign economies appeared to be strengthening more than had been anticipated, potentially adding pressure to already-taut labor markets and possibly creating inflationary imbalances that would undermine economic performance. But the FOMC viewed the risk of a significant increase in inflation in the near term as small and decided to await more evidence on how the economy was responding to its previous tightenings before changing its policy stance. However, the Committee anticipated that the evidence might well signal the need for additional tightening, and it again announced a

directive that was biased toward restraint.

Information available through mid-November pointed toward robust growth in overall economic activity and a further depletion of the pool of unemployed workers willing to take a job. Although higher real interest rates appeared to have induced some softening in interest-sensitive sectors of the economy, the anticipated moderation in the growth of aggregate demand did not appear sufficient to avoid added pressures on resources, predominantly labor. These conditions, along with further increases in oil and other commodity prices, suggested a significant risk that inflation would pick up over time, given prevailing financial conditions. Against this backdrop, the FOMC raised the target for the federal funds rate an additional $\frac{1}{4}$ percentage point in November. At that time, a symmetric directive was adopted, consistent with the Committee's expectation that no further policy move was likely to be considered before the February meeting. In a related action, the Board of Governors approved an increase in the discount rate of $\frac{1}{4}$ percentage point, to 5 percent.

At the December meeting, FOMC members held the stance of policy unchanged and, to avoid any misinterpretation of policy intentions that might unsettle financial markets around the century date change, announced a symmetric directive. But the statement issued after the meeting also highlighted members' continuing concern about inflation risks going

forward and indicated the Committee's intention to evaluate, as soon as its next meeting, whether those risks suggested that further tightening was appropriate.

The FOMC also decided on some modifications to its disclosure procedures at the December meeting, at which the working group mentioned above transmitted its final report and proposals. These modifications, announced in January 2000, consisted primarily of a plan to issue a statement after every FOMC meeting that not only would convey the current stance of policy but also would categorize risks to the outlook as either weighted mainly toward conditions that may generate heightened inflation pressures, weighted mainly toward conditions that may generate economic weakness, or balanced with respect to the goals of maximum employment and stable prices over the foreseeable future. The changes eliminated uncertainty about the circumstances under which an announcement would be made; they clarified that the Committee's statement about future prospects extended beyond the intermeeting period; and they characterized the Committee's views about future developments in a way that reflected policy discussions and that members hoped would be more helpful to the public and to financial markets.

Financial markets and the economy came through the century date change smoothly. By the February 2000 meeting, there was little evidence that demand was coming into line with

potential supply, and the risks of inflationary imbalances appeared to have risen. At the meeting, the FOMC raised its target for the federal funds rate $\frac{1}{4}$ percentage point to $5\frac{3}{4}$ percent, and characterized the risks as remaining on the side of higher inflation pressures. In a related action, the Board of Governors approved a $\frac{1}{4}$ percentage point increase in the discount rate, to $5\frac{1}{4}$ percent.

Economic Projections for 2000

The members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, expect to see another year of favorable economic performance in 2000, although the risk of higher inflation will need to be watched especially carefully. The central tendency of the FOMC participants' forecasts of real GDP growth from the fourth quarter of 1999 to the fourth quarter of 2000 is $3\frac{1}{2}$ percent to $3\frac{3}{4}$ percent. A substantial part of the gain in output will likely come from further increases in productivity. Nonetheless, economic expansion at the pace that is anticipated should create enough new jobs to keep the unemployment rate in a range of 4 percent to $4\frac{1}{4}$ percent, close to its recent average. The central tendency of the FOMC participants' inflation forecasts for 2000—as measured by the chain-type price index for personal consumption expenditures—is $1\frac{3}{4}$ percent to 2 percent, a range that runs a little to the low side of the energy-led 2 percent rise

Economic Projections for 2000

Percent

Indicator		Federal Reserve governors and Reserve Bank presidents		
		Memo: 1999 actual	Range	Central tendency
Change, fourth quarter to fourth quarter ¹	Nominal GDP	5.9	5–6	5¼–5½
	Real GDP ²	4.2	3¼–4¼	3½–3¾
	PCE Chain-type price index	2.0	1½–2½	1¾–2
Average level, fourth quarter	Civilian unemployment rate	4.1	4–4¼	4–4¼

1. Change from average for fourth quarter of 1999 to average for fourth quarter of 2000.

2. Chain-weighted.

posted in 1999.¹ Even though futures markets suggest that energy prices may turn down later this year, prices elsewhere in the economy could be pushed upward by a combination of factors, including reduced restraint from non-oil import prices, wage and price pressures associated with lagged effects of the past year's oil price rise, and larger increases in costs that might be forth-

coming in another year of tight labor markets.

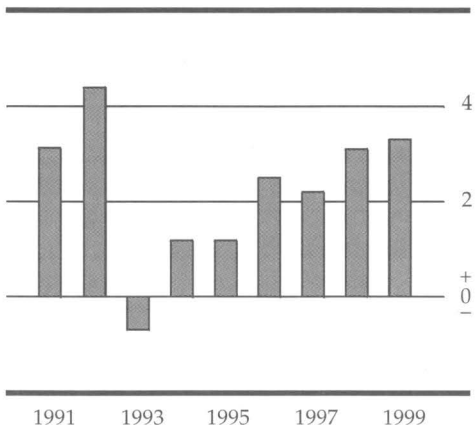
The performance of the economy—both the rate of real growth and the rate of inflation—will depend importantly on the course of productivity. Typically, in past business expansions, gains in labor productivity eventually slowed as rising demand placed increased pressure on plant capacity and on the work-

1. In past Monetary Policy Reports to the Congress, the FOMC has framed its inflation forecasts in terms of the consumer price index. The chain-type price index for PCE draws extensively on data from the consumer price index but, while not entirely free of measurement problems, has several advantages relative to the CPI. The PCE chain-type index is constructed from a formula that reflects the changing composition of spending and thereby avoids some of the upward bias associated with the fixed-weight nature of the CPI. In addition,

the weights are based on a more comprehensive measure of expenditures. Finally, historical data used in the PCE price index can be revised to account for newly available information and for improvements in measurement techniques, including those that affect source data from the CPI; the result is a more consistent series over time. This switch in presentation notwithstanding, the FOMC will continue to rely on a variety of aggregate price measures, as well as other information on prices and costs, in assessing the path of inflation.

Change in Output Per Hour

Percent, Q4 to Q4



Note. Nonfarm business sector.

force, and a similar slowdown from the recent rapid pace of productivity gain cannot be ruled out. But with many firms still in the process of implementing technologies that have proved effective in reorganizing internal operations or in gaining speedier access to outside resources and markets, and with the technologies themselves still advancing rapidly, a further rise in productivity growth from the average pace of recent years also is possible. To the extent that rapid productivity growth can be maintained, aggregate supply can grow faster than would otherwise be possible.

However, the economic processes that are giving rise to faster productivity growth not only are lifting aggregate supply but also are influencing the growth of aggregate spending. With firms perceiving abundant profit opportunities in productivity-

enhancing high-tech applications, investment in new equipment has been surging and could well continue to rise rapidly for some time. Moreover, expectations that the investment in new technologies will generate high returns have been lifting the stock market and, in turn, helping to maintain consumer spending at a pace in excess of the current growth of real disposable income. Impetus to demand from this source also could persist for a while longer, given the current high levels of consumer confidence and the likely lagged effects of the large increments to household wealth registered to date. The boost to aggregate demand from the marked pickup in productivity growth implies that the level of interest rates needed to align demand with

Wealth and Saving



1. Ratio of net worth of households to disposable personal income. The data extend through 1999:Q3.

2. The data extend through 1999:Q4

Major Stock Price Indexes

Index, January 4, 1999=100



Note. The data are daily. Last observations are for February 11, 2000.

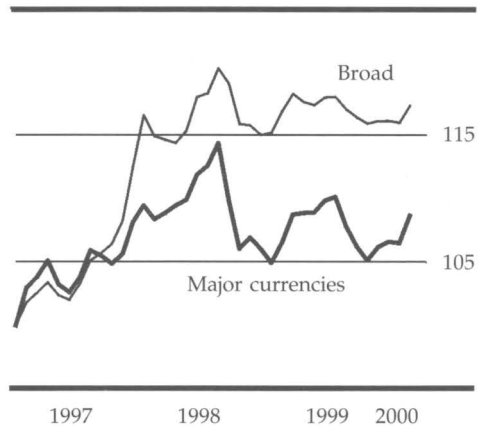
potential supply may have increased substantially. Although the recent rise in interest rates may lead to some slowing of spending, aggregate demand may well continue to outpace gains in potential output over the near term, an imbalance that contains the seeds of rising inflationary and financial pressures that could undermine the expansion.

In recent years, domestic spending has been able to grow faster than production without engendering inflation partly because the external sector has provided a safety valve, helping to relieve the pressures on domestic resources. In particular, the rapid growth of demand has been met in part by huge increases in imports of goods and services, and sluggishness in foreign economies has restrained the

growth of exports. However, foreign economies have been firming, and if recovery of these economies stays on course, U.S. exports should increase faster than they have in the past couple of years. Moreover, the rapid rise of the real exchange value of the dollar through mid-1998 has since given way to greater stability, on average, and the tendency of the earlier appreciation to limit export growth and boost import growth is now diminishing. From one perspective, these external adjustments are welcome because they will help slow the recent rapid rates of decline in net exports and the current account. They also should give a boost to industries that have been hurt by the export

Nominal Dollar Exchange Rate Indexes

Index, January 1997=100



Note. The data are monthly. Indexes are trade-weighted averages of the exchange value of the dollar against major currencies and against the currencies of a broad group of important U.S. trading partners. Last observations are for the first two weeks of February 2000.

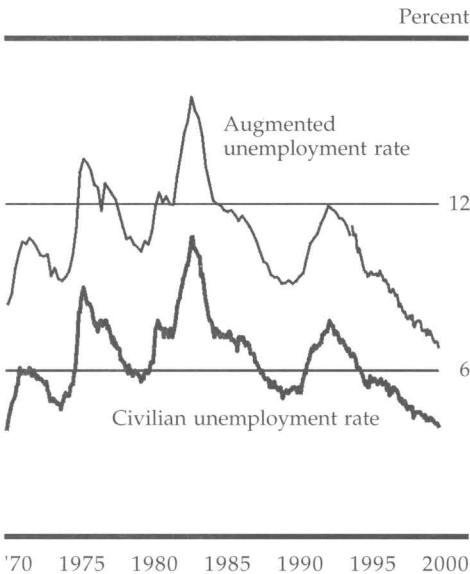
slump, such as agriculture and some parts of manufacturing. At the same time, however, the adjustments are likely to add to the risk of an upturn in the inflation trend, because a strengthening of exports will add to the pressures on U.S. resources and a firming of the prices of non-oil imports will raise costs directly and also reduce to some degree the competitive restraints on the prices of U.S. producers.

Domestically, substantial plant capacity is still available in some manufac-

turing industries and could continue to exert restraint on firms' pricing decisions, even with a diminution of competitive pressures from abroad. However, an already tight domestic labor market has tightened still further in recent months, and bidding for workers, together with further increases in health insurance costs that appear to be coming, seems likely to keep nominal hourly compensation costs moving up at a relatively brisk pace. To date, the increases in compensation have not had serious inflationary consequences because they have been offset by the advances in labor productivity, which have held unit labor costs in check. But the pool of available workers cannot continue to shrink without at some point touching off cost pressures that even a favorable productivity trend might not be able to counter. Although the governors and Reserve Bank presidents expect productivity gains to be substantial again this year, incoming data on costs, prices, and price expectations will be examined carefully to make sure a pickup of inflation does not start to become embedded in the economy.

The FOMC forecasts are more optimistic than the economic predictions that the Administration recently released, but the Administration has noted that it is being conservative in regard to its assumptions about productivity growth and the potential expansion of the economy. Relative to the Administration's forecast, the FOMC is predicting a somewhat larger rise in real GDP in 2000 and a slightly

Measures of Labor Utilization



Note. The augmented unemployment rate is the number of unemployed plus those who are not in the labor force and want a job, divided by the civilian labor force plus those who are not in the labor force and want a job. The break in data at January 1994 marks the introduction of a redesigned survey; data from that point on are not directly comparable with those of earlier periods. The data extend through January 2000.

lower unemployment rate. The inflation forecasts are fairly similar, once account is taken of the tendency for the consumer price index to rise more rapidly than the chain-type price index for personal consumption expenditures.

Money and Debt Ranges for 2000

At its most recent meeting, the FOMC reaffirmed the monetary growth ranges for 2000 that were chosen on a provisional basis last July: 1 percent to 5 percent for M2, and 2 percent to 6 percent for M3. As has been the case for some time, these ranges were chosen to encompass money growth under conditions of price stability and historical velocity relationships, rather than to center on the expected growth of money over the coming year or serve as guides to policy.

Given continued uncertainty about movements in the velocities of M2 and M3 (the ratios of nominal GDP to the aggregates), the Committee still has little confidence that money growth

within any particular range selected for the year would be associated with the economic performance it expected or desired. Nonetheless, the Committee believes that money growth has some value as an economic indicator, and it will continue to monitor the monetary aggregates among a wide variety of economic and financial data to inform its policy deliberations.

M2 increased 6¼ percent last year. With nominal GDP rising 6 percent, M2 velocity fell a bit overall, although it rose in the final two quarters of the year as market interest rates climbed relative to yields on M2 assets. Further increases in market interest rates early this year could continue to elevate M2 velocity. Nevertheless, given the Committee's expectations for nominal GDP growth, M2 could still be above the upper end of its range in 2000.

M3 expanded 7½ percent last year, and its velocity fell about 1¾ percent, a much smaller drop than in the previous year. Non-M2 components again exhibited double-digit growth, with some of the strength attributable to long-term trends and some to precautionary buildups of liquidity in advance of the century date change. One important trend is the shift by nonfinancial businesses from direct holdings of money market instruments to indirect holdings through institution-only money funds; such shifts boost M3 at the same time they enhance liquidity for businesses. Money market funds and large certificates of deposit also ballooned late in the year as a result of a substantial demand for liquidity around the

Ranges for Growth of Monetary and Debt Aggregates

Percent

Aggregate	1998	1999	2000
M2	1-5	1-5	1-5
M3	2-6	2-6	2-6
Debt	3-7	3-7	3-7

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

century date change. Adjustments from the temporarily elevated level of M3 at the end of 1999 are likely to trim that aggregate's fourth-quarter-to-fourth-quarter growth this year, but not sufficiently to offset the downward trend in velocity. That trend, together with the Committee's expectation for nominal GDP growth, will probably keep M3 above the top end of its range again this year.

Domestic nonfinancial debt grew 6½ percent in 1999, near the upper end of the 3 percent to 7 percent growth range the Committee established last February. This robust growth reflected large increases in the debt of businesses and

households that were due to substantial advances in spending as well as to debt-financed mergers and acquisitions. However, the increase in private-sector debt was partly offset by a substantial decline in federal debt. The Committee left the range for debt growth in 2000 unchanged at 3 percent to 7 percent. After an aberrant period in the 1980s during which debt expanded much more rapidly than nominal GDP, the growth of debt has returned to its historical pattern of about matching the growth of nominal GDP over the past decade, and the Committee members expect debt to remain within its range again this year.

Growth of Money and Debt

Percent

Period		M1	M2	M3	Domestic nonfinancial debt
Annual ¹	1989	0.6	5.2	4.1	7.4
	1990	4.2	4.2	1.9	6.7
	1991	7.9	3.1	1.1	4.5
	1992	14.4	1.8	0.6	4.5
	1993	10.6	1.4	1.0	4.9
	1994	2.5	0.6	1.7	4.9
	1995	-1.5	3.9	6.1	5.5
	1996	-4.5	4.5	6.8	5.4
	1997	-1.2	5.6	8.9	5.2
	1998	2.2	8.5	10.9	6.7
	1999	1.9	6.2	7.5	6.6
1999 Quarterly (annual rate) ²	Q1	1.9	7.5	8.2	6.7
	Q2	2.2	6.0	6.0	6.7
	Q3	-2.0	5.5	5.1	6.0
	Q4	5.3	5.4	10.0	6.2

Note. M1 consists of currency, travelers checks, demand deposits, and other checkable deposits. M2 consists of M1 plus savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds. M3 consists of M2 plus large-denomination time deposits, balances in institutional money market funds, RP liabilities (overnight and term), and eurodollars (overnight and term). Debt consists

of the outstanding credit market debt of the U.S. government, state and local governments, households and nonprofit organizations, non-financial businesses, and farms.

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

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