FRBSF Weekly Letter

February 12, 1988

Monetary Policy, 1987

The opening of a new year seems to be an opportune time to review United States monetary policy developments in the year just closed. Monetary policy has a profound influence on the national economy. A sound understanding of its evolution in the recent past may provide a useful perspective for a clear vision of what lies ahead.

Last year was a challenging one for U.S. monetary policy. The economy completed the fifth year of the longest peacetime expansion on record. For the first time since 1979, the unemployment rate dropped to under 6 percent, and the capacity utilization rate increased to 82 percent. Both suggested that the economy might be close to full employment, and that further strengthening of aggregate demand growth might bring back the inflationary pressures for which the nation had paid dearly to keep under control.

It was also a year in which the international aspects of the U.S. economy played an increasingly prominent part in monetary policy deliberations, giving rise to concerns over the extent to which U.S. monetary policy was aimed at maintaining the stability of the dollar rather than that of the domestic economy. And, finally, it was the year of the stock market crash, with its manifold ramifications for the economy and monetary policy.

How U.S. monetary policy met these challenges is reviewed in this *Letter*. As the year drew to a close, considerable interest was focused on the role of dollar stability and the related question of international policy coordination. With the high exchange rate volatility and concerted central bank interventions in the exchange market around the turn of the year, these issues continue to be germane to current monetary policy.

Monetary indicators

Money market conditions tightened somewhat between 1986 and 1987, up to the stock market crash in October. As shown in Chart 1, a sharp interest rate decline during the first half of 1986 was reversed in the period March through October of 1987. By October 1987, short-term interest rates recovered to where they were in March 1986, and long-term rates were higher than their levels in 1986.

The growth rates of M2 and M3 dropped from 9 percent for both in 1986 to 4.1 percent and 5.5 percent, respectively, in 1987 (Chart 1). Since bank deposit rates adjust more slowly than market rates, the decline in open market short-term rates in the first half of 1986 caused bank deposits to grow rapidly throughout that year, thereby boosting the aggregates. In contrast, the subsequent rise in open market short-term rates through much of 1987 caused the opposite.

Part of the decline in money growth rates and the rise in interest rates in 1987, however, also was due to a deliberate tightening of Federal Reserve monetary policy. In his testimony before a House subcommittee in late April, then-Fed Chairman Paul Volcker acknowledged a "somewhat less accommodative policy — a slight snugging approach" in providing reserves to banks. During most of the year up to the stock market crash, in the Federal Reserve Board's mid-year monetary policy report to Congress as well as in published records of policy actions of the Federal Open Market Committee (FOMC), which sets U.S. monetary policy, the Fed consistently stressed two immediate concerns: the risk of a resurgence of inflationary pressures and excessive declines in the exchange value of the dollar.

U.S. and abroad

The change in money market conditions between 1986 and most of 1987 was reflective also of the changes in domestic macroeconomic conditions between the two years. Chart 2 shows that, in 1986, the national economy was characterized by sluggish output growth after the first quarter, an unyielding unemployment rate hovering about a level slightly below 7 percent, and a sharp drop in the rate of consumer price inflation (due largely to an oil price decline) to a little over one percent a year — the lowest rate in the preceding twenty-five years.

Economic conditions changed in the first half of 1987. As a result of the rebound in oil prices in late 1986 and the accumulated impact of two years of dollar depreciation, the increase in the consumer price index accelerated rapidly to a 6 percent annual rate during the first quarter; it slowed somewhat in the second quarter but remained at a high 4.4 percent annual rate. During the first half of the year, output growth rose to a 3.5 percent annual rate, while the unemployment rate dropped from 6.7 percent at the start of the year to 6 percent at mid-year.

The economy appeared to be near full utilization of its productive capacity, and financial market indicators suggested rising inflation expectations. Clearly, monetary policy would need to put a greater emphasis on containing inflation in 1987 than it had done in 1986.

Meanwhile, the international environment also changed. The steep dollar depreciation since February 1985 was at first hailed as a long-overdue corrective for huge international payments imbalances. By the beginning of 1987, however, international sentiments had shifted. Primarily because of declining exports caused by their currencies' appreciation against the dollar, Japan's output growth rate had fallen from 4.7 percent in 1985 to only 2.5 percent in 1986, and Germany's had stayed at a sluggish 2.5 percent in both years. For industrial countries as a group, the average economic growth rate had declined from 3 percent in 1985 to 2.4 percent in 1986, and was expected to fall further in 1987.

Because of the dual concerns — rising inflationary pressures in the United States and the risk of economic slowdowns in the rest of the world — the finance ministers and central bank governors of the G-7 countries (Britain, Canada, France, West Germany, Italy, Japan, and the United States) agreed to limit exchange rate fluctuations through international economic policy coordination in a meeting in Paris in February 1987.

The accord, known as the Louvre agreement, soon met a severe test. The dollar, which had stabilized since the beginning of the year, began falling sharply again in mid-March despite heavy exchange market intervention by the major central banks. The dollar's decline was accompanied by sharp rises in long-term U.S. interest rates. The interest rate rises reflected the market's concern over the consequences of the dollar's decline for inflation in the United States and over a tightening of U.S. monetary policy in response to the dollar's decline. In the face of renewed dollar depreciation in mid-August, U.S. interest rates again rose, and on September 4, the Federal Reserve raised its discount rate from 5½ percent to 6 percent.

The stock market crash

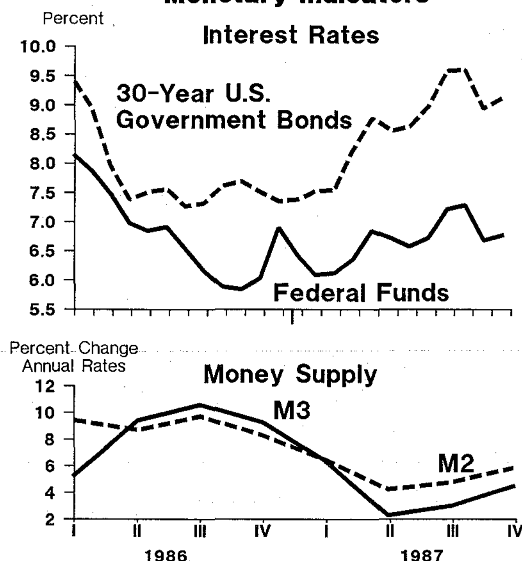
Then came the stock market crash on October 19. Observers have attributed the crash to a long list of causes, ranging from concerns over the continuing large federal budget and trade deficits to technical factors, such as program trading and interactions with the stock index futures market. Whatever its causes, the crash raised a serious risk of financial failure and a potential crisis of some magnitude.

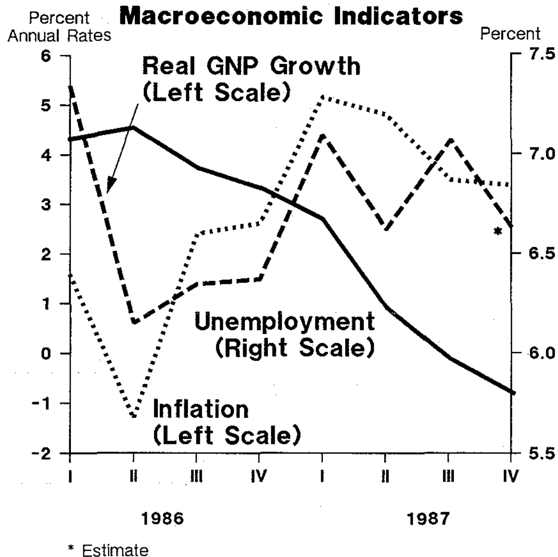
The Fed's response was prompt and forceful. In a one-sentence statement, the new Chairman Alan Greenspan assured the market of the Fed's determination to provide sufficient liquidity "to support the economic and financial system." Reserves were provided generously to accommodate banks' enhanced demand for both excess reserves and required reserves for sharply increased transactions deposits. Interest rates fell rapidly as investor preferences shifted from equity to safer and more liquid assets.

The stock market crash created a new economic environment. Given the large decline in stock prices, the prospect of continued strong consummer spending was cast in doubt. Business fixed investment was projected to grow at a slower pace, and residential construction was likely to fall somewhat in the near term. Under the circumstances, and given the unsettled conditions in financial markets, monetary policy eased after the crash.

Dollar vs. domestic stability

One week after the stock market crash, the dollar began another steep decline that carried through to year-end despite the G-7 ministerial announcement on December 22 of a renewed resolve to maintain exchange rate stability. Between October 26 and the end of the year, the trade-weighted dollar declined another 10





percent. Even though the decline was steeper than the average 3 percent decline in the March-May episode and about as steep as the 5 percent decline in the August-September episode, interest rates rose little this time.

The contrast between the three episodes of steep dollar depreciation in 1987 helps shed some light on policy actions. The tightening of monetary policy in spring and late summer was marked by a decline of the dollar combined with expectations of higher inflationary pressures and moderate domestic economic growth. In contrast, during the November-December period, monetary policy eased in spite of the dollar decline, in an environment of general apprehension over the unsettled conditions in financial markets and the impact of the stock market crash on the economy. The contrast in policy stance during the three episodes clearly indicates that, where a choice had to be made, the Fed placed greater emphasis on domestic economic and financial market stability than on dollar stability.

International policy coordination

At the time of this writing in January, the exchange market remains unsettled. The G-7 ministers' statement on December 22 expressed their desire for dollar stability. The unanswered question, beyond the scope of this *Letter,* is to what extent they are ready to adjust their national economic policies to achieve dollar stability.

What this review of U.S. monetary policy in 1987 does show, however, is that there is no evidence to indicate that the Fed was willing to let its desire for dollar stability undermine its primary goal of domestic economic stability.

Nor is it reasonable — one might add — to expect otherwise, of the Fed or any other central bank. International policy coordination can contribute to exchange rate stability only to the extent that it is also consistent with the goal, common to all the G-7 governments, of sustained domestic output growth at a low rate of inflation. Attaining this common goal is of particular importance in the U.S. case because of the pivotal role of the Unites States in the world economy.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.
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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/20/88	Change from 1/13/88	Change from 1/21/87 Dollar	Change from 1/21/87 Percent[7]
Loans, Leases and Investments[1 2]	203,916	278	4,996	2.5
Loans and Leases[1 6]	180,840	227	1,934	1.1
Commercial and Industrial	51,073	– 171	– 2,458	– 4.5
Real estate	70,667	– 70	4,173	6.2
Loans to Individuals	36,437	4	– 4,750	– 11.5
Leases	5,829	– 12	406	7.4
U.S. Treasury and Agency Securities[2]	16,025	56	2,869	21.8
Other Securities[2]	7,051	– 4	128	1.8
Total Deposits	204,050	797	– 1,308	– 0.6
Demand Deposits	51,893	1,326	– 1,030	– 1.9
Demand Deposits Adjusted[3]	32,288	– 2,179	– 2,748	7.8
Other Transaction Balances[4]	20,185	– 273	1,113	5.8
Total Non-Transaction Balances[6]	131,972	– 256	– 1,391	– 1.0
Money Market Deposit Accounts—Total	43,311	230	– 3,959	8.4
Time Deposits in Amounts of $100,000 or more	29,884	– 513	– 1,703	– 5.3
Other Liabilities for Borrowed Money[5]	23,511	1,435	– 8,672	– 26.9

Two Week Averages of Daily Figures	Period ended 1/11/88	Period ended 12/28/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	2	37
Borrowings	20	15
Net free reserves (+)/Net borrowed(–)	– 17	22

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change