Monetary Policy Report to the Congress

Report submitted to the Congress on February 20, 1996, pursuant to the Full Employment and Balanced Growth Act of 1978[1]

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. 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.

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 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 percent to 40 percent last year and have moved still higher in early 1996. 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 Group of Ten (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

1. The charts for the report are available on request from Publications Services, Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, DC 20551.

the currencies of a broader group of U.S. trading partners, the dollar's real depreciation in 1995 was even smaller.

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.

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 having declined for more than fifteen years. The growth in depository credit was funded primarily with deposits, 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 having increased 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 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 has also 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

1. Economic projections for 1996

Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents: Range	Federal Reserve Governors and Reserve Bank presidents: Central tendency	Administration
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, fourth quarter			
Civilian unemployment rate	5½–6	5½–5¾	5.7[4]

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

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. 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.

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 gross domestic product.

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. 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 Reserve 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. 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

2. 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.

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.

THE PERFORMANCE OF THE ECONOMY

Measured in terms of the chain-type indexes that are now being emphasized by the Bureau of Economic Analysis, growth of real GDP averaged slightly less than 1½ percent at an annual rate over the first three quarters of 1995 after a gain of 3½ percent in 1994. The rise in aggregate output this past year was accompanied by an increase in payroll employment of 1¾ million, and the unemployment rate, after having fallen sharply in 1994, held fairly steady over the course of 1995, keeping to a range of about 5½ percent to 5¾ percent. Consumer prices, as measured by the CPI for all items, rose 2¾ percent over the four quarters of 1995, an increase that was virtually the same as those of the two previous years.

Growth of output during the past year was slowed in part by the actions of businesses to reduce the pace of inventory accumulation after a burst of stockpiling in 1994. Final sales—a measure of current output that does not end up in inventories—rose at an average rate of 2 percent over the first three quarters of 1995 after an increase of 3 percent over the four quarters of 1994. The slowing of final sales was largely a reflection of a downshifting in growth of the real outlays of households and businesses, from elevated rates of increase in 1994 to rates that were more sustainable. Real government outlays for consumption and investment edged down slightly, on net, during the first three quarters of 1995. Increases in real exports and real imports of goods and services were smaller than those of 1994; their combined contribution to GDP growth in the first three quarters was slightly negative.

The Household Sector

Real personal consumption expenditures rose at an annual rate of about 2¼ percent over the first three quarters of 1995 after having risen slightly more than 3 percent over the four quarters of 1994. Available data suggest that growth of real outlays slowed further in the fourth quarter. The reduced rate of rise in consumption spending this past year came against the backdrop of moderate gains in employment and income. The financial wealth of households surged, but impetus to spending from this source evidently was countered by other influences, such as increases in debt burdens among some households and an apparent rise, according to survey data, in consumers' concerns about job security.

Real consumer expenditures for durable goods increased at an annual rate of 2¼ percent over the first three quarters of 1995, a slower rate of rise than in other recent years. Consumer expenditures for motor vehicles declined slightly, on net, over the first three quarters after having moved up nearly 20 percent over the three previous years; in the fourth quarter, unit sales of cars and light trucks, a key indicator of real outlays for vehicles, were down slightly from their third-quarter pace. Incentive programs that provided price concessions of one sort or another to buyers probably gave some lift to sales in 1995. However, "pent-up" demand, which had helped to boost sales earlier in the expansion, probably was no longer an important factor. Recent sales data do not seem to point to any big shifts in demand for vehicles around the turn of the year: The average rate of sales of cars and light trucks in December and January was a touch above the average for 1995 as a whole.

Real outlays for durable goods other than motor vehicles continued to rise at a brisk pace in 1995 but not so rapidly as in other recent years. Spending for furniture and household equipment hit a temporary lull in the first part of 1995 but picked up again over the next two quarters, lifted in part by a rebound in construction of new houses. Fourth-quarter data on retail sales seem to point to a further sizable increase in outlays for household durables; according to most anecdotal accounts, spending for home computers and other electronic gear, which has been surging in recent years, continued to move up rapidly through the latter part of 1995.

Consumer expenditures for nondurables increased at an annual rate of about 1½ percent, in real terms, over the first three quarters of 1995, a little less than the average of the previous ten years and considerably less than in 1994. The growth of real expenditures on apparel slowed sharply after three years of sizable advances. In the fourth quarter, real outlays for nondurables appear to have been lackluster.

Real expenditures for services—which account for more than half of total consumer outlays—increased at an annual rate of about 2¾ percent over the first three quarters of 1995, moderately faster than in either 1993 or 1994. After having declined in 1994, outlays for energy services increased sharply over the first three quarters of 1995: The unusually mild weather of late 1994 gave way, first, to more normal winter conditions in early 1995 and, later on, to hot summer weather that lifted fuel requirements for cooling. Spending gains for other categories of services proceeded at an annual rate of about 2¼ percent over the first three quarters of 1995, about the same rate of rise as in the two previous years.

Real disposable personal income rose at an average annual rate of about 2½ percent over the first three quarters of 1995, a gain that was about in line with the previous year's increase. Monthly data through November suggest that growth of real income may have picked up a little in the fourth quarter. Nominal personal income appears to have increased slightly faster in 1995 than it did in 1994, and growth of nominal disposable income, which excludes income taxes, apparently held close to its 1994 pace. Inflation continued to take only a moderate bite from increases in nominal receipts: The chain-type price index for personal consumption expenditures rose at an annual rate of 2½ percent over the first three quarters of 1995, matching, almost exactly, the increases in each of the two previous years.

After little change during 1994, the real value of household wealth surged in 1995. The value of assets was boosted substantially by huge increases in the prices of stocks and bonds. Liabilities continued to rise fairly rapidly but at a rate well below the rate of increase in household assets; rapid growth of consumer credit was again the most notable feature on the liability side. Behind these aggregate measures of household assets and liabilities was some wide variation in the circumstances of individual households. Appreciation of share prices and the rally in the bond market provided a substantial boost to the wealth of households holding large amounts of those assets. However, households holding few such assets benefited little from the rally in securities prices, and some of these households began to experience greater financial pressure in 1995. Debts taken on earlier proved to be difficult to repay in some instances, and a rising number of households saw their loans fall into delinquency. Overall, however, the incidence of financial stress among households appears to have been limited, as sustained increases in personal income helped to facilitate timely repayment of obligations.

Consumers maintained relatively upbeat perceptions of current and future economic conditions during 1995. The measure of consumer confidence that is prepared by the Conference Board held fairly steady at a high level. The index of consumer sentiment that is compiled by the University of Michigan Survey Research Center edged down a little, on net, from the end of 1994 to the end of 1995, but its level also remained relatively high. By contrast, some survey questions dealing specifically with perceptions of labor market conditions pointed to increased concerns about job prospects during the year; although employment continued to rise in the aggregate, announcements of job cuts by some major corporations may have rekindled consumers' anxieties about job security. In January of this year, consumer assessments of labor market conditions softened further, and the broader indexes of sentiment also declined. The January levels of the indexes were on the low side of their averages of the past couple of years but were well above levels that were reported through most of the first three years of the expansion.

Consumers tended to save a slightly higher proportion of their income in 1995 than they had in 1994. Large increases in financial wealth usually cause households to spend a greater share of their current income, thereby reducing the share of income that is saved. However, rising debt burdens and increased nervousness about job prospects would work in the opposite direction, and these influences may have offset the effect of increases in wealth. Some households also may have started focusing more intently on saving for retirement, especially in light of increased political debate about curbing the growth of entitlements provided under government programs. Nonetheless, the personal saving rate for all of 1995, while moving up a little, remained in a range that was relatively low by historical standards.

Residential investment fell in the first half of 1995 but turned up in the third quarter. Both the downswing in the first half and the subsequent rebound after midyear appear to have been shaped, at least in a rough way, by swings in mortgage interest rates. Although housing activity had been slow to respond to increases in mortgage interest rates through much of 1994, sizable declines in sales of new and existing homes started to show up toward the end of that year, and by early 1995, permits and starts also were dropping. However, the decline in activity proved to be relatively short and mild. By March, mortgage interest rates already were down appreciably from the peaks of late 1994, and midway through the second quarter, most indicators of housing activity were starting to rebound. Sales of new homes surged to especially high levels during the summer, and permits and starts of single-family units rose appreciably. In the autumn, sales retreated from their midyear peaks. Starts also slipped back somewhat during the autumn, but permits held firm.

The intrayear swings in the various housing indicators left the annual totals for these indicators at fairly elevated levels. The average pace of sales of existing homes over the first eleven months of 1995 was well above the average for the 1980s, even after having adjusted for increases in the stock of houses. Starts and sales of new single-family dwellings in 1995 were about one-tenth higher than their averages for the 1980s. So far in the 1990s, demographic influences have been less supportive of housing activity than in the 1980s, as the rate of household formation has lagged—in part because many young adults have delayed setting up their own domiciles. However, an offsetting impetus to demand has come from the improved affordability of housing, brought about in particular by declines in mortgage interest rates.

Construction of multifamily units, after having taken a notable step toward recovery in 1994, rose only moderately further in 1995. Over the first eleven months of 1995, starts of multifamily units amounted to 280,000 at an annual rate, compared with about 260,000 the previous year and a low of 162,000 in 1993. Financing for the construction of new multifamily projects appeared to be readily available this past year. However, the national vacancy rate for multifamily rental units, while down from the peaks of a few years ago, remained relatively high, and increases in rents were not of a magnitude to provide much incentive for the construction of new units.

The Business Sector

Most indicators of business activity remained favorable in 1995, but strength was less widespread than it had been in 1994, and growth overall was less robust. The output of all nonfarm businesses rose at an annual rate of slightly less than 2 percent over the first three quarters of 1995, after a gain of 4 percent in 1994—a pace that could not have been sustained given already high operating levels. Inventory problems cropped up in some lines of manufacturing and trade in 1995 and prompted production adjustments. Scattered structural problems were apparent as well, especially in parts of retail trade in which intense competition for market share caused financial losses and eventual bankruptcy for some enterprises. More generally, however, business profits remained high in 1995, as firms continued to emphasize strategies that have served them well throughout the 1990s—most notably, tight control over costs and rapid adoption of new technologies, achieved by way of heavy investment in high-tech equipment.

In total, real business fixed investment increased at an annual rate of 8 percent over the first three quarters of 1995 after a gain of 10 percent in 1994. Growth in business spending for equipment continued to outpace the growth of investment in structures, even though the latter scored its largest gain of the past several years. On a quarterly basis, investment remained very strong through the first quarter of 1995. After having slowed sharply in the spring, it then picked up somewhat in the third quarter. Fragmentary data for the fourth quarter suggest that investment in plant and equipment recorded a gain of at least moderate size in that period.

Businesses continued to invest heavily in computers in 1995. In real terms, these expenditures rose at an annual rate of nearly 30 percent over the first three quarters of the year, an increase that was even more rapid than that of 1994. Excluding computers, real investment outlays increased less rapidly, on balance, than in 1994, and growth after the first quarter was modest, on net. In the equipment category, outlays for information-processing equipment other than computers moved up at an annual rate of about 13 percent in the first half of 1995 but fell back a little in the third quarter. Spending for industrial equipment followed a roughly similar pattern, with a small third-quarter decline coming on the heels of large gains in the first half of the year. Real outlays for transportation equipment declined in the second quarter but rebounded in the third. Real investment in nonresidential structures moved up in each of the first three quarters of 1995, at an annual rate of more than 6 percent, on average, after a gain of 3½ percent during 1994; the most recent year brought increased construction of most types of nonresidential buildings.

In the industrial sector, elevated levels of investment in equipment and structures in 1995 led to a gain of about 4 percent in industrial capacity. However, in a turnabout from the outcome of the previous year, output of the industrial sector rose considerably less rapidly than capacity: A gain of 1½ percent in total industrial production over the four quarters of 1995 was a sharp slowdown from a 1994 rise of more than 6½ percent. Production of consumer goods followed a choppy pattern during 1995 and rose less than ½ percent over the year as a whole, the smallest annual increase of the current expansion. The output of business equipment advanced in each quarter, but a cumulative gain of 4½ percent for this category was smaller than the increases of other recent years. Production of materials faltered temporarily in the second quarter, but production gains resumed thereafter, leading to a rise of about 2¼ percent over the four quarters of the year.

With capacity expanding rapidly and production growth slowing, the rate of capacity utilization in industry turned down sharply in 1995, backing away from the high operating rates of late 1994. As of this past December, the utilization rate in manufacturing was about ½ percentage point above its long-term average. In January of this year, utilization rates fell noticeably: Vehicle producers reduced assembly rates last month, and winter storms temporarily shut down manufacturing operations more generally.

After having risen rapidly during 1994, business inventories continued to build at a substantial pace in the early part of 1995. By the end of the first quarter, real inventories of nonfarm businesses were about 5½ percent above the level of a year earlier. Meanwhile, strength that had been evident in final sales during 1994 gave way to more subdued growth in the first quarter of 1995, and the ratio of inventories to sales rose. In the second and third quarters, growth of inventories was roughly in line with growth of business final sales; consequently, aggregate inventory–sales ratios held fairly steady during this period. Although data on inventory change in the year's final quarter are not yet complete, the available indicators suggest that significant imbalances probably were present in only a few industries at year-end. Potential for wider inventory problems appears to have been contained through a combination of production restraint late in 1995, caution in ordering merchandise from abroad, and discounting by some retailers during the holiday shopping season. Wholesalers reduced their inventories in the final two months of 1995, and manufacturers' stocks rose only slightly; aggregate inventory–sales ratios moved down in both sectors.

Business profits rose further over the first three quarters of 1995. Economic profits of all U.S. corporations increased at an annual rate of nearly 11 percent, a pace similar to that seen over the four quarters of 1994. The profits of corporations from their operations in the rest of the world moved up sharply, on net, and earnings from domestic operations also continued to advance. The strongest gains in domestic profits came at financial corporations and reflected, in part, an increased volume of lending by financial institutions, reduced premiums on deposit insurance at commercial banks, and rising profits of securities dealers. The economic profits earned by nonfinancial corporations from their domestic operations rose at an annual rate of about 3½ percent over the first three quarters of 1995 after three years in which the annual increases were 15 percent or more. A moderation of output growth at nonfinancial corporations and a flattening of the rise in profits per unit of output both worked to reduce the rate of growth in nominal earnings in 1995. Nonetheless, with unit costs also moving up at a moderate pace, the share of the value of nonfinancial corporate output that ended up as profits changed little, on net, in the first three quarters, holding in a range that was relatively high in comparison to the average profit share over the past couple of decades.

The Government Sector

At the federal level, combined real outlays for investment and consumption fell at an annual rate of about 4¼ percent over the first three quarters of 1995, dropping to a level about 13 percent below its annual peak in 1990. Both investment and consumption were cut back over the first three quarters of 1995. Outlays for defense continued to contract, and nondefense expenditures turned down, reversing a moderate increase that took place over the four quarters of 1994.

Federal outlays in the unified budget, which covers items such as transfers and grants, as well as consumption and investment expenditures other than the consumption of fixed capital, rose 3¾ percent in nominal terms in fiscal 1995, matching almost exactly the percentage rise of the previous fiscal year. Nominal outlays for defense declined 3¼ percent in both fiscal 1995 and fiscal 1994. Outlays for social security increased about 5 percent in both years. Spending for Medicare and Medicaid continued to rise at rates appreciably faster than the growth of nominal GDP. Net interest payments jumped in fiscal 1995 after three years of relatively little change, but working in the other direction, net outlays for deposit insurance were more negative than in 1994 (that is, the margin between insurance premiums and the payout for losses increased). Proceeds from auctions of spectrum rights also helped to hold down expenditures; like the premiums for deposit insurance, these proceeds enter the budget as a negative outlay. In the first three months of fiscal 1996—that is, the three-month period ended in December—federal outlays were about 1 percent lower in nominal terms than in the comparable period of fiscal 1995. Nominal outlays for defense have continued to trend down this fiscal year, and the spending restraint embodied in recent continuing budget resolutions has translated into sharp cuts in nondefense outlays.

Federal receipts rose 7½ percent in fiscal 1995, after having increased 9 percent in fiscal 1994. In both years, categories of receipts that are most closely related to the state of the economy showed sizable increases. With receipts moving up more rapidly than spending in fiscal 1995, the federal budget deficit fell for a third consecutive year, to $164 billion. Progress in reducing the deficit in recent years has come from cyclical expansion of the economy, tax increases, nonrecurring factors such as the sale of spectrum rights, and adherence to the budgetary restraints embodied in the Budget Enforcement Act of 1990 and the Omnibus Budgetary Reconciliation Act of 1993.

The economic expansion also has helped to relieve budgetary pressures that many state and local governments were experiencing earlier in the 1990s. Excluding social insurance funds, surpluses in the combined current accounts of state and local governments were equal to about ½ percent of nominal GDP in the first three quarters of 1995; this figure was more than double the average for 1991 and 1992, when budgetary pressures were most severe.

Even so, state and local budgets remain at the center of strongly competing pressures, with the demand for many of the services that typically are provided by these governments continuing to rise at a time when the public also is expressing desire for tax relief. Although states and localities have responded to these pressures in different ways, the aggregate picture is one in which expenditures and revenues have continued to rise faster than nominal GDP—but by smaller margins than in the early part of the 1990s. In total, the current expenditures of state and local governments, made up mainly of transfers and consumption expenditures, were equal to about 12½ percent of nominal GDP in the first three quarters of 1995, up slightly from the percentages of the two previous years and about 1¾ percentage points higher than the comparable figure for 1989. Total receipts of state and local governments were equal to about 13¾ percent of nominal GDP in the first three quarters of 1995, up just a touch from the comparable percentages of the two previous years but about 1¼ percentage points higher than the percentage in 1989.

State and local outlays that are included in GDP have been rising less rapidly than the current expenditures of these jurisdictions because GDP excludes transfer payments, which have been growing faster than other outlays. In real terms, combined state and local outlays for consumption and investment increased at an annual rate of about 2½ percent over the first three quarters of 1995. Real investment expenditures, which consist mainly of outlays for construction, moved up at an annual rate of almost 7 percent. By contrast, consumption expenditures, which are about four times the size of investment outlays, rose only modestly in real terms—at an average annual rate of about 1½ percent.

The External Sector

Growth of real GDP in the major foreign industrial countries other than Japan slowed sharply in 1995 from the robust rates of 1994. In Canada, where economic activity had been particularly vigorous through the end of 1994, the slowdown reflected weaker U.S. growth as well as macroeconomic policies intended to achieve improved fiscal balance and to prevent the reemergence of inflationary pressures. In Germany and the other European economies, appreciation of their currencies in terms of the dollar during the early months of the year and efforts to reduce public sector deficits contributed to the decline in the rate of real output growth. In contrast, Japan showed some tentative signs of recovery late in 1995 after almost no growth during the previous three years.

With the expansion of real GDP slowing in the foreign G-10 countries at a time when some slack remained, inflation stayed low. The average rate of consumer price inflation in these countries remained about 2 percent last year, essentially the same as in 1994 and somewhat less than in the United States.

Economic growth in the major developing countries slowed on average in 1995 from the strong pace recorded for 1994. The substantial contraction of economic activity in Mexico had important effects on U.S. trade, but real output also slowed in other developing countries, including Argentina. In response to the December 1994 collapse of the Mexican peso, the Mexican government adopted a set of policies intended to tighten monetary conditions, maintain wage restraint, and reduce government spending to mitigate the inflationary impact of the peso's devaluation and to achieve significant reduction in the current account deficit in 1995. Through the third quarter, the Mexican current account was approximately balanced; a deficit of about $20 billion had cumulated during the comparable three quarters of 1994. The merchandise trade balance improved to moderate surplus in 1995 from a substantial deficit in 1994. The improved trade performance in part reflected a severe contraction in aggregate demand. Mexican real output fell sharply early in the year but picked up toward the end of the year, for an annual decline of nearly 7 percent.

The newly industrializing economies in Asia—for example, Malaysia, Korea, and Taiwan—continued to grow rapidly during 1995, at about the same rate as in 1994. Although growth in most of these countries was driven by a strong expansion in internal demand, especially in investment, most countries also benefited from very fast export growth. The marked acceleration in exports was attributable at least in part to a real depreciation of their currencies against the yen and key European currencies during the early part of the year.

In the first eleven months of 1995 the nominal U.S. trade deficit in goods and services reached about $115 billion at a seasonally adjusted annual rate, a level slightly greater than the $106 billion recorded for 1994. U.S. income growth in 1995 was similar to the average for our trading partners, but as is typically the case, comparable increases in income seemed to bring forth an increase in U.S. demand for imports that was larger than the average increases in demand for our exports by the foreign countries with which we trade. Effects of the dollar's depreciation during 1994 and early 1995 worked in the opposite direction, tending to boost exports and hold down imports. Overall, the result of these offsetting tendencies was that the dollar value of exports grew somewhat faster than the dollar value of imports through November. Nonetheless, with the level of imports exceeding the level of exports at the start of the year, these growth rates translated into a slightly larger deficit. The current account deficit averaged about $160 billion at an annual rate during the first three quarters of 1995. Both the trade deficit and the deficit on net investment income widened somewhat, resulting in an increase from the $150 billion current account deficit experienced in 1994.

Real exports of goods and services grew at an annual rate of about 5 percent over the first three quarters of 1995. Agricultural exports remained at elevated levels, and the volume of computer exports continued to rise sharply. Other merchandise exports expanded in real terms at a marginally slower rate than did the total; within this broad category, machinery and industrial supplies accounted for the largest increases. Tabulation of the export data by country of destination showed divergent patterns: Exports to Mexico dropped in response to the economic crisis in that country, but shipments to developing countries in Asia rose sharply. Exports to Western Europe, Canada, and Japan increased as well.

Imports of goods and services increased at an annual rate of about 6 percent in real terms during the first three quarters, a slower rate of advance than during 1994. Imports of computers and semiconductors rose sharply, but imports of other machinery, consumer goods, and industrial supplies slowed. Import prices increased about 2½ percent in the twelve months ending in December 1995. An end to the very rapid rise in world non-oil commodity prices and low inflation abroad helped to restrain the rise in import prices.

In the first three quarters of 1995, recorded net capital inflows into the United States were substantial and nearly balanced the deficit in the U.S. current account. Sharp increases were reported in both foreign assets in the United States and U.S. assets abroad.

Foreign official asset holdings in the United States increased almost $100 billion through September. These increases reflected both intervention by certain industrial countries to support the foreign exchange value of the dollar and very substantial accumulation of reserves by several developing countries in Asia and Latin America. Private foreign assets in the United States also rose rapidly. Net purchases of U.S. Treasury securities by private foreigners totaled $97 billion, an amount far exceeding previous records. Net purchases of U.S. government agency bonds and corporate bonds were also very large.

Direct investment inflows reached almost $50 billion in the first three quarters of 1995; this total was about equal to the inflow during all of 1994 and almost matched the record pace of 1989. Mergers and acquisitions added substantially to the inflow of funds from foreign direct investors in the United States. U.S. direct investment abroad was even larger than foreign direct investment in the United States and also approached previous peak rates. U.S. net purchases of foreign stocks and bonds were up from 1994 but below the 1993 peak rate. The bulk of the net U.S. purchases of foreign securities were from the industrial countries; net purchases from emerging markets played a relatively small role.

Labor Markets

The number of jobs on nonfarm payrolls increased 1¾ million over the twelve months ended in December 1995. After a sharp rise during 1994, gains in employment slowed in the first part of 1995, and the second quarter brought only a small increase. Thereafter, increases picked up somewhat. Nearly 450,000 jobs were added in the final three months of the year, a gain of about 1½ percent at an annual rate. In January of this year, with the weather keeping many workers at home during the reference week for the monthly survey of establishments, payroll employment fell sharply.

As in 1994, increases in payroll employment in 1995 came mainly in the private sector of the economy, but gains there were more mixed than those of 1994. In manufacturing, employment fell about 160,000 over the twelve months ended in December, reversing almost half of the previous year's gain. Losses were concentrated in industries that produce nondurables. A decline this past year in the number of jobs at apparel manufacturers was one of the largest ever in that industry. Sizable reductions in employment also were reported by manufacturers of textiles, tobacco, leather products, and petroleum and coal. In many of these industries, cyclical deceleration of the economy in 1995 compounded the effects of adjustments stemming from longer-run structural changes. In contrast to the widespread contraction in employment among producers of nondurables, employment at the manufacturers of durable goods increased slightly during 1995. Hiring continued to expand briskly at firms that produce business equipment. Metal fabricators also sustained growth in employment but at a slower pace than in 1994. The number of jobs in transportion equipment declined, on net.

In most other sectors of the economy, employment rose moderately last year. The number of jobs in construction increased 140,000 over the twelve months ended in December, a rise of more than 3 percent. In the private service-producing sector, which now accounts for about three-fourths of all jobs in the private sector, employment increased 1.7 million in 1995 after having advanced 2.6 million in 1994. Establishments that are involved in wholesale trade continued to boost payrolls at a relatively brisk pace in 1995. Retailers also added to employment but at a considerably slower rate than in 1994; within retail trade, employment at apparel outlets fell substantially last year, and payrolls at stores selling general merchandise dropped moderately after a large increase in 1994. Providers of health services added slightly more jobs than in other recent years. At firms that supply services to other businesses, employment growth was sizable again in 1995 but less rapid than in either of the two previous years; in this category, providers of computer services expanded their job counts at an accelerated pace in 1995, but suppliers of personnel—a category that includes temporary help agencies—added jobs at a much slower rate than in other recent years.

Results from the monthly survey of households showed the civilian unemployment rate holding in a narrow range throughout 1995, and the rate reported in December—5.6 percent of the labor force—was near the midpoint of that narrow range. In January of this year, the unemployment rate ticked up to 5.8 percent.

The proportion of working-age persons choosing to participate in the labor force edged down slightly, on net, over the course of 1995. It has changed little, on balance, since the start of the 1990s. By contrast, the two previous decades brought substantial net increases in labor force participation, although longer-term trends during the two decades were interrupted at times by spells of cyclical sluggishness in the economy. Two or three years ago, cyclical influences also seemed to be a plausible explanation for the sluggishness of labor force participation in the current business expansion. But, with the participation rate remaining sluggish as job opportunities have continued to expand, the evidence is pointing increasingly toward a slower rate of rise in the trend of participation. Slower growth of participation will tend to limit the growth of potential output unless an offsetting rise is forthcoming in the trend of productivity growth. So far in the current expansion, measured increases in productivity seem to have followed a fairly typical cyclical pattern, with larger increases early in the expansion and smaller gains, on average, in subsequent years. Overall, however, this pattern has not yielded evidence of a significant pickup in the longer-term trend of productivity growth.

The average unemployment rate for all of 1995 was about ½ percentage point below the average for 1994, and it was only a little above the levels to which the unemployment rate fell in the latter stages of the long business expansion of the 1980s. The low unemployment rates reached back then proved to be unsustainable, as they eventually were accompanied by a significant step-up in the rate of inflation, brought on in part by faster rates of rise in hourly compensation and unit labor costs. The current expansion, in contrast, has remained relatively free of increased inflation pressures working through the labor markets. The employment cost index for hourly compensation of workers in private nonfarm industries rose only 2.8 percent over the twelve months ended in December, the smallest annual increase on record in a series that goes back to the start of the 1980s. Hourly wages increased 2.8 percent during the past year, the same relatively low rate of increase as in 1994. The cost of fringe benefits, prorated to an hourly basis, rose only 2.7 percent last year, the smallest annual rise on record. With many firms still undergoing restructurings and reorganizations, many of which have involved permanent job losses, workers probably have been more reluctant to press for wage increases than they normally would have been during a period of tight labor markets. Also, firms have been making unprecedented efforts to gain better control over the rate of rise in the cost of benefits provided to employees, especially those related to health care. Although some of these efforts may have only a one-time effect on the level of benefit costs, groundwork also seems to have been laid for slower growth of benefits over time than would otherwise have prevailed.

Prices

Early in 1995, inflation pressures that had started building in 1994 seemed to be gaining in intensity. Indexes of spot commodity prices continued to surge in the early part of last year, and in the producer price index, materials prices recorded some of the largest monthly increases of the past decade and a half. Consumer prices also began to exhibit some upward pressure, with the index for items other than food and energy moving up fairly rapidly over the first four months of the year.

The surge in inflation proved to be relatively short-lived, however. The spot prices of industrial commodities turned down in the spring of the year and fell further, on net, after midyear. Price increases for intermediate materials slowed in the second and third quarters of 1995, and by the final quarter of the year these prices also were declining. Monthly increases in the core CPI slowed in May; thereafter, increases generally were small over the remainder of the year. The slowing of the economy after the start of the year appears to have cut short the buildup of inflationary pressures before they could have much effect on the underlying processes of wage and price determination. In the end, the rise in the CPI excluding food and energy from the final quarter of 1994 to the final quarter of 1995 amounted to 3 percent, an increase that differed little from those of the two previous years. The increase in the total CPI in 1995 came in at 2¾ percent, the fifth consecutive year in which it has been in a range of 3 percent or less.

In the aggregate, rates of price increase held fairly steady for both goods and services this past year. The CPI for commodities other than food and energy rose 1¾ percent over the four quarters of 1995 after increases of 1½ percent in both 1993 and 1994. The last three-year period in which prices of these goods rose by such small amounts came in the middle part of the 1960s. Apparel prices continued to decline last year but not so rapidly as in the previous year. Price increases for vehicles moderated. The 1995 rise in the CPI for services other than energy was 3¾ percent; although this increase exceeded the 1994 rise by a slight amount, the results for both years were among the smallest increases for this category in the last three decades.

Trends in food prices and energy prices remained favorable to consumers in 1995. The rise in food prices from the final quarter of 1994 to the final quarter of 1995 was slightly more than 2½ percent, almost exactly the same as the increases of the two previous years. The last yearly increase in food prices in excess of 3 percent came five years ago, in 1990. In the intervening years, production adjustments by farmers and weather problems of one sort or another have caused temporary surges in the prices of some farm commodities, but these surges have not resulted in widespread pressures on food prices at the retail level. Moderate rates of increase in the costs of nonfarm inputs that contribute heavily to value added have been an important anchor in the setting of food prices at the consumer level. Also, if only by chance, years of poor crops—like that of 1995, when grain and oilseed production plummeted—have tended to be interspersed with years of good crops, a pattern that has prevented sustained upward pressures on farm and food prices. In the energy area, prices at the consumer level fell 1¾ percent, on net, over the four quarters of 1995, more than reversing a moderate 1994 increase. Gasoline prices dropped nearly 5 percent, on net, over the four quarters of the year, and consumer prices of natural gas also declined appreciably. However, some upward pressures developed in late 1995 and early this year, largely in response to unexpectedly cold temperatures that boosted fuel requirements for winter heating.

All told, the price developments of 1995 appear to have left a favorable imprint on expectations of future rates of inflation, if results from various surveys of consumers and forecasters are an accurate reflection of the views held by the broader public. Monthly responses to the surveys tend to bounce around somewhat, but over 1995 as a whole, average readings of anticipated price increases one year into the future were slightly lower than those of 1994, and survey responses about inflation prospects over the longer term came down more substantially. Although the responses regarding expected inflation still tended, on balance, to run to the high side of actual rates of price increase, the easing of inflation expectations this past year provided another encouraging sign that inflation processes that helped to undermine other recent business expansions are still in check in the current expansion.

Financial, Credit, and Monetary Developments

In 1995 and early 1996, the Federal Reserve had to adjust its policy stance several times to promote credit market conditions supportive of sustained growth with low inflation. At the beginning of 1995, some risk remained that inflation might rise. To provide additional insurance against that development, the Federal Open Market Committee (FOMC) tightened reserve conditions, raising the intended federal funds rate ½ percentage point, to 6 percent, thereby extending the episode of policy firming that had begun one year earlier. As time passed, it became clear that these policy tightenings had been successful in containing inflationary pressures, and the System initiated ¼ point reductions in the federal funds rate in July and December 1995 and January 1996.

Most market interest rates had peaked before the policy tightening last February. During the spring, interest rates declined appreciably, as market participants increasingly came to believe that no additional policy restraint would be forthcoming, and, indeed, that easing might be in the cards. Mounting evidence that the growth of spending had downshifted and price pressures were muted, along with greater hopes that substantial progress would be made toward reducing the federal budget deficit, contributed to the change in attitudes and to the drop in interest rates, especially longer-term rates. On balance during 1995, interest rates dropped 1 to 2½ percentage points, with the largest declines registered on intermediate- and long-term securities. This year, short- and intermediate-term interest rates have fallen somewhat further, while long-term rates are unchanged to a little higher.

During the first part of last year, expectations of lower U.S. interest rates relative to other G-10 countries and other factors such as the crisis in Mexico contributed to a 10 percent depreciation of the trade-weighted exchange value of the dollar. By year-end, though, the dollar had retraced about half of these losses, and it has appreciated further on balance in 1996.

The course of interest rates during the year influenced overall credit flows and their composition. The expansion of the total debt of domestic nonfinancial sectors was relatively strong during the first half of the year but moderated later in 1995. For the year, debt grew 5¼ percent, a bit above the midpoint of its annual growth range. Initially, household and nonfinancial business credit demands were concentrated in floating-rate or short-term debt instruments. As the yield curve flattened, credit demands shifted to fixed-rate, long-term debt instruments.

Because depository institutions are important sources of short-term and floating-rate credit to households and businesses, depository assets grew rapidly early on and then backed off. The need to fund the increase in assets, along with declines in market interest rates relative to yields on retail deposits, led to the fastest growth in M2 and M3 since the late 1980s; M2 ended the year in the upper part of its annual range, and M3 was at the upper end of its range. In contrast, M1 declined for the first time since the beginning of the official series in 1959, as many banks introduced retail sweep accounts that shifted deposits from interest-bearing checking accounts to savings-type accounts in order to reduce reserve requirements.

The Course of Policy and Interest Rates

The Federal Reserve entered 1995 having tightened policy appreciably during the previous year. Short-term interest rates had risen more than 2½ percentage points from the end of 1993, and long-term rates were up 2 percentage points. Policy tightening had been necessitated by the threat of rising inflation posed by unusually low real short-term interest rates earlier in the 1990s. Rates had been kept low to counter the effects of impediments to credit flows and economic growth. But as these impediments were reduced, the economy expanded at an unsustainable pace and margins of underutilized labor and capital began to erode. Ultimately, absent a firmer policy, excessive demands on productive resources and resulting higher inflation would have produced strains, threatening economic expansion.

In early February the policy actions taken in 1994 did not appear to be sufficient to head off inflationary pressures. The growth of economic activity had not shown convincing signs of slowing to a more sustainable pace, and available information, including a marked rise in materials prices during the last half of 1994, seemed indicative of emerging resource constraints and building inflationary pressures. In these circumstances, the FOMC agreed on a ½ percentage point increase in the federal funds rate, and the Board of Governors approved an equal increase in the discount rate.

During the remainder of the winter and through the spring, incoming data signaled that economic growth was finally moderating. At first, it was unclear if the slowdown was temporary or if it was a lasting shift toward a sustainable rate of economic expansion in the neighborhood of the economy's potential. Adding to the uncertainty was a pickup of consumer price inflation and a pronounced weakening in the foreign exchange value of the dollar. At the March meeting, the FOMC determined that it would be prudent to await further information before taking any additional policy actions, but it alerted the Manager of the System Open Market Account that, if intermeeting action were to be required, the step would more likely be to firm than to ease.

By the May meeting, substantial evidence had accumulated that the threat of rising inflation had lessened. Economic growth had slowed; although the adjustment to inventory imbalances that had developed earlier in the year was contributing to the slowdown, the underlying trajectory of final sales was still uncertain. The FOMC determined that the existing stance of policy was appropriate and expressed no presumption as to the direction of potential policy action over the intermeeting period, issuing a symmetric directive to the Account Manager.

Intermediate- and long-term interest rates had fallen throughout the winter and spring, as evidence accumulated that the expansion of economic activity was slowing and that inflationary pressures were ebbing. Furthermore, budget discussions in the Congress seemed to foreshadow significant fiscal restraint over the balance of the decade, putting additional downward pressure on these rates. Short-term rates had declined less, but in late spring, financial market participants had begun to anticipate an easing of monetary policy. By midyear, the three-month Treasury bill rate had declined about ¼ percentage point from its level at the beginning of the year, while rates on securities with maturities greater than one year had dropped as much as 2 percentage points.

Employment data released shortly after the May FOMC meeting were surprisingly weak, and by the July meeting it appeared that growth of aggregate output had sagged markedly during the second quarter as businesses sought to keep inventories from rising to undesirable levels. This deceleration of output growth was accompanied by a softening of industrial prices and a marked reduction in the pace at which materials prices were rising. With the economy growing more slowly than had been anticipated and potential inflationary pressures receding, the FOMC voted to ease reserve pressures slightly with a ¼ percentage point decline in the intended federal funds rate.

Although financial market participants had anticipated a decline in the federal funds rate at some point, bond and equity markets rallied strongly immediately after the change in policy was announced. However, a pickup in economic growth during the summer made further reductions in the funds rate appear less likely, and interest rates backed up for a time.

The Committee did keep rates unchanged at the August and September meetings. Although inflation had improved, the slowdown had been anticipated to a considerable extent. Moreover, uncertainties about federal budget policies and their effects on the economy remained substantial.

At the November meeting, the economic signals were mixed. Anecdotal information tended to suggest a softening in spending after the third quarter, but the extent of any slowing of spending and inflation was unclear. Although short-term rates remained above long-term averages on a real, inflation-adjusted basis, substantial rallies in bond and stock markets were thought likely to buoy spending. Against this backdrop, the FOMC voted to maintain the existing stance of monetary policy.

The generally positive news about inflation and hopes for a budget agreement had helped propel the bond market higher throughout the fall. By the December meeting, intermediate- and long-term interest rates were 1¾ to 2½ percentage points below their levels at the beginning of the year. The bond market rally, along with strong earnings reports, pushed equity prices higher during the year, and by mid-December, equity price indexes were up about 35 percent from levels at the beginning of the year. Since the last easing in July, inflation had been somewhat more favorable than anticipated, and the expansion of economic activity had moderated substantially after having posted a strong third quarter. With both inflation and inflation expectations more subdued than expected, and with the slowing in economic growth suggesting that price pressures would continue to be contained, the FOMC decided to reduce the intended federal funds rate an additional ¼ percentage point, bringing it to 5½ percent.

The data available at the time of the FOMC meeting in late January gave stronger evidence of slowing economic expansion. This development reduced potential inflationary pressures going forward and raised questions about whether monetary policy might unduly restrain the pace of expansion. The Committee believed that a further slight easing in monetary policy was consistent with keeping inflation contained and fostering sustainable growth, given that price and cost trends were already subdued. In these circumstances, the Committee lowered the intended federal funds rate ¼ percentage point, to 5¼ percent, and the Board approved an equivalent reduction in the discount rate, to 5 percent.

Partly as a consequence of the System actions in December and January, short- and intermediate-term interest rates have fallen ¼ to ½ percentage point since mid-December. However, on balance, longer-term rates are unchanged to a little higher. The absence of a firm agreement to reduce the federal budget deficit, and some tentative signs most recently that the economy might not be so sluggish as some market participants had feared, have held up longer-term rates.

Credit and Money Flows

On balance in 1995, the debt of the domestic nonfinancial sectors grew at about the same pace as in the previous year, although within the year, debt growth was much stronger in the first half than in the second. Credit supplies remained plentiful: Banks continued to be willing lenders, and in securities markets most interest-rate spreads remained quite narrow. Debt burdens for households increased, but except for a few types of consumer credit obligations, delinquency rates remained at low levels. Rising equity prices bolstered the overall financial condition of households.

Federal debt rose 3¾ percent in 1995, slightly less than in 1994. The federal government's demands for credit fell largely because the budget deficit shrank about 20 percent for the calendar year. Federal debt growth also slowed toward year-end as the Treasury drew down its cash balance to keep borrowing within the $4.9 trillion debt ceiling.

State and local government debt fell 5½ percent—more than in 1994. A few years earlier, municipalities had taken advantage of low long-term rates to pre-refund a substantial volume of issues, many of which were eligible to be called in 1995. As those securities were called, and with gross issuance light, the stock of municipal securities contracted for a second consecutive year. Despite the overall reduction in debt outstanding, the ratios of tax-exempt to taxable yields jumped in the first half of the year and, for long-term debt, held at an elevated level during the remainder of the year. This increase was associated with concerns about the effect on demands for tax-free municipal debt of proposals for changes in federal taxation that would sharply reduce the tax advantages of holding municipal bonds.

Household borrowing remained robust in 1995, moderating only a bit from 1994, and the ratio of household debt to disposable personal income rose further. Even so, the financial condition of this sector remained good on balance, although there were signs

3. 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
Quarter (annual rate) [3]				
1995:1	−.1	1.4	4.8	5.3
2	−.5	4.3	6.7	7.0
3	−1.5	7.0	8.0	4.6
4	−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.

of deterioration. The rally in the domestic equity markets supported household balance sheets by boosting net worth sharply. In addition, delinquency rates on home mortgages and closed-end consumer loans at banks, while rising, remained at low levels. Other indicators, however, provided evidence that some households were likely beginning to experience increased financial pressures. For instance, delinquency rates on credit card debt held by banks and on auto loans booked at captive finance companies rose sharply. Furthermore, the average household debt-service burden—calculated as the share of disposable income needed to meet required payments on mortgage and consumer debt—continued to rise last year. This measure of debt burden has now reversed about one-half of the decline it posted earlier in the decade.

The average debt-service burden of nonfinancial corporations—the ratio of net interest payments to cash flow—also rose last year, but it remained well beneath the most recent peak reached in 1990. The increase in debt burden was in part associated with the relatively strong growth of the debt of nonfinancial businesses. This sector's debt growth was especially robust early in the year, when business fixed investment picked up further and inventory accumulation was rapid. Debt issuance was also boosted by the rising wave of mergers, although a good number involved stock swaps. Financing needs fell back later on as investment growth slowed and profits increased. Funding patterns also shifted as bond yields fell, and firms relied more heavily on longer-term debt. Despite the increase in credit demands, interest rate spreads of investment-grade private securities over comparable Treasuries widened only slightly and remained narrow by historical standards, suggesting that lenders continued to view balance sheets of nonfinancial corporations as remaining healthy on the whole. Spreads on below-investment-grade debt rose more sharply but stayed well beneath levels reached early in the decade.

Commercial banks met a significant portion of the increase in business credit demands last year, which, in turn, contributed to the rapid expansion of bank balance sheets. Banks funded a portion of the loan increase by reducing their securities holdings, although higher market prices of securities and off-balance-sheet contracts left reported securities holdings slightly higher for the year. In fact, bank security holdings relative to the size of their balance sheets remained elevated and, together with banks' strong capital positions, indicated that late in the year banks were well positioned to continue accommodating the credit demands of households and businesses. Although qualitative information suggested that banks were no longer reducing the standards businesses needed to meet to qualify for loans, some easing of credit terms continued, with interest rate spreads on business loans narrowing further. Growth of real estate loans held by banks slowed over the year as the share of fixed rate mortgages in total originations rose with the decline in long-term rates. Banks tend to securitize fixed rate mortgages more than adjustable rate loans. Consumer loans on the books of banks began the year growing at very high rates; this growth decelerated throughout 1995 as the volume of securitization increased. In response to rising delinquency rates, some banks tightened terms and standards for consumer loans toward the end of 1995 and early 1996.

Total assets of thrift institutions are estimated to have risen slightly last year. Growth at healthy thrift institutions more than offset a substantial transfer of thrift assets to commercial banks through mergers. The revival of growth in thrift assets, along with the strong showing of bank credit, helped to nudge up depository credit as a share of domestic nonfinancial debt for the second straight year after fifteen years of declines. Banks and thrift institutions still account for more than one-third of all credit to nonfinancial sectors.

Banks and thrift institutions funded a large share of their asset growth with deposits, and M3 grew 6 percent. The non-M2 portion of M3 was especially strong, in part as depository institutions substituted large time deposits for nondeposit sources of funds. The sharp reduction in deposit insurance premiums, which made large time deposits a more attractive source of funds, probably contributed to this shift. Late in the year, branches and agencies of Japanese banks, facing some resistance in U.S. funding markets, ran off time deposits while continuing to increase their funding from overseas offices.

M2 rose as lower market interest rates and a flatter yield curve increased the relative attractiveness of retail deposits.[2] As is typical, deposit interest rates,

4. Distribution of bank assets by capital status

Percentage of industry assets

	1990:Q4	1995:Q3
Undercapitalized	31.3	.5
Adequately capitalized	38.6	2.9
Well capitalized	30.1	96.6

NOTE. Adjusted for examiner ratings.

2. In February 1996 M2 was redefined to exclude overnight repurchase agreements (RPs) and overnight Eurodollars; these instruments

and to a lesser extent returns on money market mutual funds, adjusted slowly to declines in market rates last year. Falling interest rates for comparable maturity market instruments were not the whole story for the growth of M2, however. As the yield curve flattened, the relative gains from holding longer-term assets with less certain price behavior fell, and this probably strengthened household demand for components of M2. Even so, M2 velocity was about unchanged after having increased for four years.

M1 fell almost 2 percent in 1995, the first annual decline since the beginning of the Board's official series in 1959. Sweeps of deposits from reservable checking accounts, a component of M1, to nonreservable money market deposit accounts were a major influence. Without these sweeps, M1 would have risen 1 percent. By the end of last year, sweeps had spread to thirty-two bank holding companies, and the initial amounts swept by these programs totaled $54 billion. The corresponding decline of more than $5 billion in required reserves largely showed through to reserve balances maintained at Federal Reserve Banks. As banks continue to introduce retail sweep programs in the future, the aggregate level of required reserve balances will tend to fall further. Although it has not happened yet, one possible consequence of the declining required reserve balances is greater instability in the aggregate demand for reserves and in overnight interest rates. In 1991, after the cut in reserve requirements at the end of 1990, unusually low levels of required reserve balances were associated with greater variability in the federal funds rate, as banks' volatile clearing needs began to dominate the demand for reserves, making daily reserve demand more difficult to estimate.

The run-off in reserve balances held down the growth of the monetary base to 4 percent in 1995. In addition, currency growth slowed, primarily owing to reduced shipments abroad. Foreign demand moderated with the stabilization of financial conditions in some countries where dollars circulate widely. Indeed, reduced demands from abroad contributed to a rare decline in the currency component of M1 this past summer, the first decrease since the early 1960s. The demand for existing Federal Reserve notes also slackened in anticipation of the introduction of a newly designed $100 bill that will be more difficult to counterfeit.

will remain in M3. These items were first included in M2 in 1980 because they were being substituted for demand deposits as businesses were in the process of managing their cash holdings more closely. Since then, other uses of overnight RPs and Eurodollars have come to dominate movements. Moreover, while RPs and Eurodollars are only 3 percent of M2, they contribute substantially to the short-run volatility of that aggregate. Removing these components from M2 should make the weekly levels of the aggregate less volatile and reduce the reporting burden on banks that have had to distinguish between overnight and term RPs and Eurodollars. On a monthly and quarterly basis, the relationships of the two measures of M2 to income and interest rates are almost indistinguishable. The historical M2 data presented in this report exclude overnight RPs and overnight Eurodollars.

Foreign Exchange Developments

The weighted-average foreign exchange value of the dollar in terms of the other G-10 currencies declined about 5 percent on balance last year. The dollar fell sharply through April and reached a low almost 10 percent below its value at the end of 1994. The downward pressure against the dollar was sparked by indications of some slowing of the pace of U.S. real output growth, which contributed to expectations that further increases in U.S. interest rates were unlikely, and by the acrimony surrounding the ongoing trade dispute between the United States and Japan. The crisis in Mexico also weighed on the dollar. On several occasions in March and early April the Trading Desk at the Federal Reserve Bank of New York, joined by some other central banks, intervened to buy dollars on behalf of the Department of the Treasury and the Federal Reserve System in an effort to counter the pressure for dollar depreciation.

The release by the G-7 officials of the communiqué from their meeting in late April supporting an orderly reversal of the dollar's decline and the signing of a trade agreement between the United States and Japan at the end of June helped to stabilize the dollar, which had fluctuated narrowly until early August. The dollar then rebounded somewhat and remained within a narrow range through the end of the year. The recovery of the dollar stemmed, in part, from perceptions that its earlier decline, particularly in terms of the yen, had been excessive in light of the underlying fundamentals. Moreover, weakness in the economies of some other major industrial countries began to emerge, reducing prospective returns available abroad. At times from May through August, the Trading Desk again entered the market in conjunction with other central banks to intervene in support of the dollar, reinforcing the view that U.S. authorities were committed to a strong dollar.

In all of the major foreign industrial countries, long-term interest rates declined during 1995, nearly reversing the increases that had occurred during the previous year. On average, rates on foreign government issues with maturities of ten years fell about 150 basis points in the twelve months to December, somewhat less than the decline that occurred in the comparable U.S. rate. In Canada, where economic activity slowed sharply, the drop in long-term rates nearly matched that in the United States, while in Italy, where political uncertainty remained a concern throughout the year, rates fell only 100 basis points. During the first few weeks of this year, long-term rates abroad generally moved down somewhat more but then most recently returned to their December average levels. An important exception is Japan, where rates have risen from their late-December levels, apparently reflecting market perceptions that the stage is set for a Japanese economic recovery. Short-term market rates in the major foreign industrial countries were mixed, but on average rates moved down.

On balance, the dollar depreciated about 8 percent in terms of the German mark during 1995 and by similar amounts in terms of most other currencies participating in the Exchange Rate Mechanism of the European Union. After substantial depreciation against the mark early in the year, the dollar stabilized and then partly recovered as economic indicators revealed significant softening in economic activity in Germany. Easing by the Bundesbank during the second half of the year reinforced the view that mark interest rates were not likely to rise and might fall further. The dollar depreciated slightly, on balance, in terms of the Canadian dollar, despite periods of selling pressure on the Canadian dollar during the year related to Canada's fiscal situation and possible secession by Quebec.

Although the dollar did fall to a record low, below 80 yen to the dollar in mid-April, by year-end the dollar had appreciated slightly in terms of the yen from its level at the end of 1994. So far this year, the dollar has appreciated somewhat further against the yen. Resolution of the trade dispute and repeated episodes of exchange market intervention by the Bank of Japan, sometimes in conjunction with U.S. and foreign monetary authorities, contributed to the appreciation of the dollar in terms of the yen during the second half of the year. However, the fundamental cause of the yen's decline during that period probably was the easing of monetary policy by the Bank of Japan that pushed short-term market interest rates to extremely low levels.

In terms of the Mexican peso, the dollar appreciated sharply from the onset of the crisis in late December 1994 to March. The dollar subsequently retraced some of those gains, and the peso–dollar rate fluctuated narrowly through the middle of the year. Uncertainty about the prospects for Mexican economic performance and macroeconomic policy sparked renewed appreciation of the dollar in terms of the peso in November. Since November, data indicating that the decline in Mexican real economic activity may have ended, some intervention by the Bank of Mexico in support of the peso, and a perception that the decline in the peso may have gone too far given the underlying fundamentals have contributed to some rebound of the peso. During the year, the Mexican authorities drew $3 billion on short-term swap lines with the Federal Reserve and the Exchange Stabilization Fund (ESF) of the U.S. Treasury and $10.5 billion on a medium-term swap facility provided by the ESF. By the end of January 1996, the short-term drawings had been entirely repaid.

Adjusted for relative consumer price inflation, the dollar was little changed, on balance, against a multilateral-trade-weighted average of the currencies of eight developing countries that are important U.S. trading partners. The dollar's 30 percent real appreciation against the Mexican peso was about offset by real depreciations against the other seven currencies. □