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The National Economy in 1985

The U.S. economy continued to increase its output in 1985, but at a much slower pace than in the two preceding years of the current economic expansion. Problems that began to emerge after mid-1984 became sources of real weakness in 1985. In particular, the large foreign trade imbalance caused both an overall slowing and an uneven pattern of growth across different sectors. This occurred despite a decline in interest rates of some 300 basis points since mid-1984.

Policymakers sought to redress these structural imbalances through legislation to curb the growth in federal spending and through international accords designed to reduce the value of the dollar. In the area of monetary policy, the Federal Reserve's efforts to support noninflationary growth were complicated by the aberrant behavior of the M1 monetary aggregate—an important indicator of the thrust of monetary policy.

Uneven expansion

Over the last three years, the total volume of goods and services produced by the U.S. economy has advanced to a level ten percent higher than the previous peak in 1981. In the process, some nine million new jobs have been created, the unemployment rate has dropped from 10.7 percent to 7.1 percent of the civilian labor force, and the proportion of adults at work has risen to a post-war high of 60 percent. This good news, however, has been marred by the number of industries that have not shared in the overall prosperity. Industries such as forest products, mining and some manufacturing sectors have seen little or no employment growth since 1982. Agriculture has been especially hard-hit, with an actual loss of half a million jobs over this period.

To an important extent, the emergence of this "dual economy", in which some sectors (such as finance and services) prosper while others remain depressed, may be traced to the impact of increased foreign competition resulting from the substantial appreciation in the international value of the U.S. dollar between mid-1980 and early 1985. Industries producing goods for export found that the dollar's rise made their products more expensive in foreign markets while, at home, the high value of the dollar made imported goods cheaper compared to those produced by U.S. firms. The resulting sluggish growth of exports and surge in imports showed up in a sharp deterioration in the nation's current account. That account moved from a small surplus in 1980 to an estimated $120 billion deficit in 1985.

Policy initiatives

It is now widely agreed that these developments have a common cause: the burgeoning deficit in the federal government's budget. Between 1981 and 1983, this deficit almost tripled and became a significant factor in the sharp rise in real, or inflation-adjusted, interest rates. At about 5 percent of GNP for the last three years, the deficit has absorbed some three-fifths of the net savings of households, businesses and state and local governments. The result is that real interest rates remain high by historical standards. Since 1981, for example, the real return on U.S. Treasury Bills has fluctuated around four percent, compared to an average of less than two percent in the two decades prior to 1970.

These relatively high rates, in turn, helped attract the massive inflow of foreign capital needed to finance the federal budget deficit. This capital inflow has been the largest single factor driving up the value of the dollar and producing the deteriorating trade position noted earlier. In a sense, then, most of the burden of financing the budget deficit has fallen on the U.S. industries that are exposed to foreign competition in either their domestic or overseas markets. This competition has led to growing demands by these industries for some form of protection. Other parties have expressed concern that the heavy foreign borrowing has transformed the U.S. into a net debtor nation.

In an effort to remedy this situation, and perhaps head off protectionist sentiments, Congress enacted the Gramm-Rudman-Hollings bill in late 1985, calling for a gradual reduction in the size of the deficit until a balanced budget is achieved in 1991. This legislation is intended to redress the major structural imbalance in the economy and to provide relief over time to those sectors of the economy that have suffered from the indirect effects of the budget deficit.

Of greater immediate impact on the foreign balance were the efforts of U.S. and other central banks to bring down the value of the dollar through substantial foreign exchange intervention first in late February and again in the fall. The second round of intervention followed the September "Group of Five" Agreement among the U.S., the United Kingdom, France, West Germany and Japan. This agreement aimed to encourage orderly depreciation of the dollar through better coordination of economic policies.

These efforts and, more importantly, the slowdown in the rate of growth of the U.S. economy and subsequent declines in interest rates, have pushed down the dollar's value by some 24 percent since last February. Although the dollar remains 47 percent above its value in June 1980, the depreciation experienced in 1985 should set the stage in 1986 for a significant improvement in the trade balance and in the prospects for industries that have been hurt by foreign competition.

Inflation

Last year continued the transition to an environment of lower inflation that began in 1982. Unlike past upswings that saw the rate of inflation pick up as real output continued to expand, this recovery has been characterized by a *declining* rate of inflation. At its peak in 1980, the twelve-month rate of change in the consumer price index registered an alarming 14.7 percent. By contrast, over 1985, the third year of recovery, this index of inflation rose only 3.6 percent.

A lower rate of inflation provides a solid basis for sustained economic growth over the long-run. However, the transition from the environment of rapid inflation in the late 1970s and early 1980s to the new situation of only modest price increases has been painful for certain sectors. With lowered inflation expectations, investors no longer demand real assets as a hedge against rising prices. Consequently, the prices of real assets such as houses, office buildings, and agricultural land have fallen relative to the overall price level. During the 1970s, the annual rate of price increase of these types of real estate was consistently higher than the overall rate of inflation. In 1985, the situation was reversed. Farmers, in particular, who also faced stiffened foreign competition for their products, have been hurt by the decline in the value of agricultural land.

Monetary policy

In 1985, the principal concern of the Federal Reserve in conducting monetary policy was to facilitate the transition of the economy to a sustainable rate of growth with low inflation. As the negative effects of the budget deficit began to make themselves felt via the worsening trade balance, the Federal Reserve sought to guide the economy to a "soft landing" at full employment. At the same time, in view of the costs involved in bringing the rate of inflation down to more tolerable levels, it remained alert to the risks of rekindling inflationary pressures. The task of conducting monetary policy was further complicated in 1985 by a breakdown in the usual relationship between the growth rates of GNP and the Federal Reserve's principal monetary target, M1, which comprises the stocks of currency and checkable deposits in the hands of the public.

As the year began, M1 was rising rapidly and, by July, was well above the Federal Reserve's 4-7 percent growth target for the year. Ordinarily, this rapid monetary growth would be a signal that spending on goods and services and therefore, prices would be rising rapidly as well. Instead, GNP growth remained surprisingly sluggish as the velocity of M1—the rate at which M1 is spent—declined. Faced with this decline in velocity and with some uncertainty as to whether it would continue, the Federal Reserve set a new and wider 3-8 percent M1 target for the second half of the year. This target also was exceeded by a significant margin as velocity continued to fall.

Economists are divided both as to the causes of this unexpected velocity decline and as to whether the decline will continue. Most agree that the drop in market interest rates, declining inflation and continued deregulation of the banking industry played roles. All of these developments reduce the cost (in terms of foregone earnings on alternative investments) of holding money, making the public more willing to hold M1 balances than in the past. Under these circumstances, the Federal Reserve decided that M1 growth above the target set at mid-year would be acceptable, especially since the other monetary aggregates used as targets remained within their target ranges. In particular, the Federal Reserve gave greater attention in conducting policy to ongoing developments in the overall economy, the credit markets, and foreign exchange markets, and less attention to movements in the narrow monetary aggregate.

Outlook

The past year has been one of transition. As is normal when a cyclical expansion lengthens, overall growth has slowed. The severity of this overall slowdown has thrown the problems of individual sectors into sharp relief. These problems have been associated with the federal budget deficit, the deteriorating foreign trade balance, and the process of adjustment to lower inflation. However, in response to these problems, both interest rates and the international value of the dollar have come down, and monetary policy has been conducted with a view to accommodating these needed adjustments. Lower interest rates and a weaker dollar are expected to provide a basis for continued moderate, but sustainable, growth without additional inflation.

The decline in the value of the dollar, which began last year, should provide a boost to the economy in 1986 as it leads to an improvement in the foreign trade balance. Although cuts in federal spending sufficient to achieve the deficit target mandated by the Gramm-Rudman Amendment will have a depressing effect on the economy, this effect should be offset by improvements in interest rate sensitive sectors such as housing and business investment. Moreover, the cutbacks will also reduce federal demands on the credit markets and, thus, the upward pressure on interest rates.

Considerable uncertainty surrounds the trend in consumer spending, which accounts for some 70 percent of aggregate demand. In 1985, households increased their spending more rapidly than their incomes, causing the overall saving rate to fall sharply. Some economists suggest that this decline will be reversed in 1986 as households seek to reduce their debt burdens and to increase their asset holdings. However, slower growth in consumption is not expected to halt the overall business expansion.

This year, 1986, will see completion of the process of deregulating deposit rates payable by banks and other financial intermediaries mandated by the Monetary Control Act of 1980. The effects on the behavior of the monetary aggregates are not expected to be large. However, in view of the behavior of M1 and velocity in 1985, the Federal Reserve will probably continue to emphasize developments in the economy, in the broader monetary aggregates, and in the credit and foreign exchange markets in setting policy.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/25/85	Change from 12/18/85	Change from 12/26/84 Dollar	Change from 12/26/84 Percent[7]
Loans, Leases and Investments[1 2]	199,810	332	10,048	5.2
Loans and Leases[1 6]	181,438	312	9,893	5.7
Commercial and Industrial	51,918	– 19	– 1,459	– 2.7
Real estate	65,911	– 151	3,833	6.1
Loans to Individuals	38,493	159	6,487	20.2
Leases	5,499	14	420	8.2
U.S. Treasury and Agency Securities[2]	10,553	– 187	– 723	– 6.4
Other Securities[2]	7,819	207	879	12.6
Total Deposits	203,516	806	8,006	4.0
Demand Deposits	51,879	850	4,983	10.6
Demand Deposits Adjusted[3]	34,241	544	3,330	10.7
Other Transaction Balances[4]	14,607	48	1,970	15.5
Total Non-Transaction Balances[6]	137,030	– 92	1,052	0.7
Money Market Deposit Accounts—Total	45,913	25	4,460	10.7
Time Deposits in Amounts of $100,000 or more	37,732	– 87	– 3,638	– 8.7
Other Liabilities for Borrowed Money[5]	25,381	– 1,532	4,630	22.3

Two Week Averages of Daily Figures	Period ended 12/16/85	Period ended 12/2/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	56	68
Borrowings	44	148
Net free reserves (+)/Net borrowed(–)	12	– 79

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