The U.S. Economy and Monetary Policy in 1984

By J. A. Cacy and Glenn H. Miller, Jr.

Midyear 1984 appears to have been an important watershed for the current economic expansion. Rapid growth through 1983 was followed by even more rapid growth in the first half of 1984, accompanied by further declines in the unemployment rate and continued moderation in inflation. After mid-1984, economic growth slowed markedly and the unemployment rate leveled off, while inflation remained moderate.

Financial developments in 1984 moved in a similar pattern. Rising interest rates and rapid money growth early in the year were succeeded by falling interest rates and sluggish money growth. Monetary policy actions also tended to move with economic developments in 1984.

This article provides a review of the economic and financial developments of 1984 and examines the factors contributing to them. The article also briefly discusses the outlook for economic activity and the posture for monetary policy in 1985.

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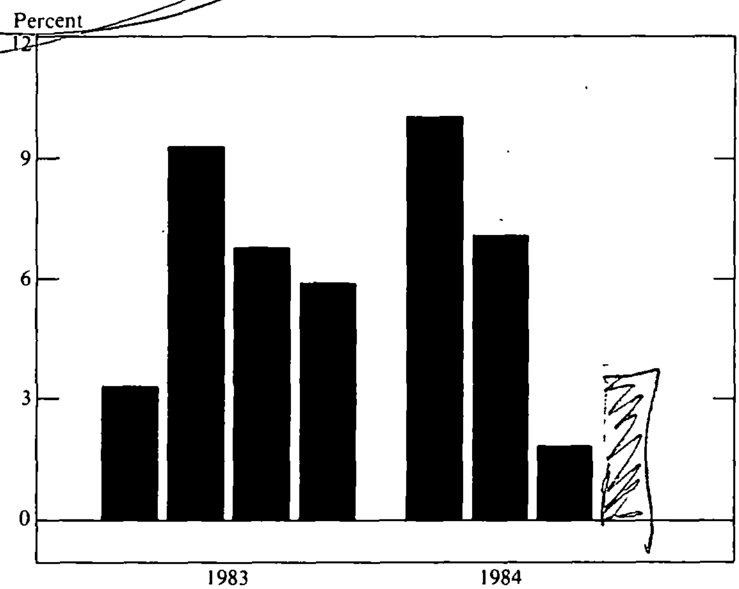
Economic performance in 1984

The first half of 1984 was a time of continued strong economic expansion. Real GNP rose sharply, the unemployment rate declined, and wages and prices continued to rise moderately. Several factors contributed to good economic performance, including monetary and fiscal policies, a strong dollar, business fixed investment, consumer spending, and labor costs and union settlements.

Stronger GNP growth in the first half of 1984 came from all major spending sectors except net exports. Real GNP grew at an annual rate of about 8.5 percent in the first half of the year, accelerating from a rate of 6.3 percent in 1983 (Chart 1). Business fixed investment continued to boom at a 21 percent annual rate in the first half of 1984, while residential construction and government purchases both increased at annual rates of about 10 percent. Personal consumption expendi-

CHART 1
Change in real GNP
(seasonally adjusted annual rate)

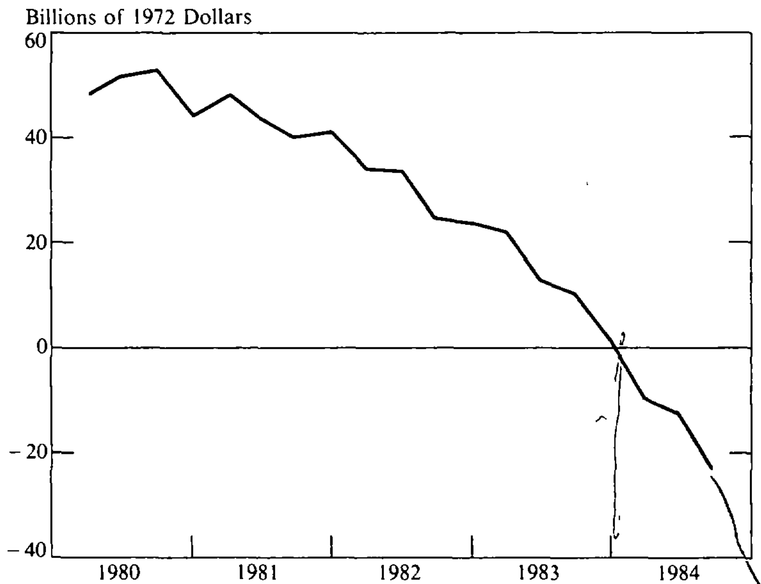


tures increased at an annual rate of about 6 percent, making up nearly half of the total dollar increase in real GNP. Inventory accumulation also contributed to strong GNP growth in the first half of 1984. Net exports of goods and services, however, continued to decline sharply (Chart 2) and made a substantial drag on GNP growth. In the first half of 1984, the increase in the real dollar value of U.S. imports was nearly four times the modest rise in U.S. exports.

Resource use, reflecting the rapid pace of economic activity in the first half of 1984, strengthened with output growth. Employment increased strongly and the unemployment rate fell from 8.2 percent at the end of 1983 to 7.1 percent in June 1984. The rate of capacity use in manufacturing rose from 79 percent at the end of 1983 to 82 percent in June 1984.

Moderation in price inflation also continued in the first half of 1984. The GNP deflator rose at an annual rate of about 3.8 percent, and the Consumer Price Index (CPI) remained in the neighborhood of 4 percent (Chart 3). Wage inflation, as shown by the increase in the average hourly earnings index, continued to slow steadily through the first half of 1984, rising at an annual rate of just under 3.5 percent (Chart 4). Unit labor costs—compensation per hour divided by output per hour or productivity—grew at a modest 1 percent annual rate in the first half of 1984 and put little upward pressure on prices. Productivity growth accelerated, contributing even more than moderate compensation growth to keeping the rise in unit labor costs modest.

CHART 2
Real net exports of goods and services
(seasonally adjusted annual rate)



The slowdown in economic growth after midyear was substantial. Real GNP growth was sharply lower in the third quarter—increasing at a rate of only 1.9 percent (Chart 1). All the third-quarter rise in real GNP was attributable to a more rapid accumulation of inventories. Consumption barely increased at all, as consumer purchases of both durable and nondurable goods declined. Net exports also declined sharply, as the increase in imports was about six times as large as the increase in exports. Growth in business fixed investment and government purchases was less than their rapid second-quarter advances and was not enough to offset declines in other sectors. Indicators for the autumn months, while somewhat mixed, indicate that economic activity remained sluggish in the fourth quarter.

Resource use after midyear continued to reflect the pace of economic activity. The civilian unemployment rate in November was 7.2 percent, slightly higher than its 1984 low of 7.1 percent in June. The November rate of capacity use in manufacturing was below its June level, after reaching a post-recession peak in July.

Inflation after midyear remained moderate, as the GNP deflator rose at a 3.7 percent rate in the third quarter and the CPI rose at an annual rate of 4.6 percent over the three months ending in October. Changes in wages and labor costs gave a mixed picture for the third quarter. Average hourly earnings grew more slowly in the third quarter than in the first half of 1984 and did not grow at all in October. Compensation growth was somewhat

CHART 3

Change in consumer price index

(percentage change from one year earlier)

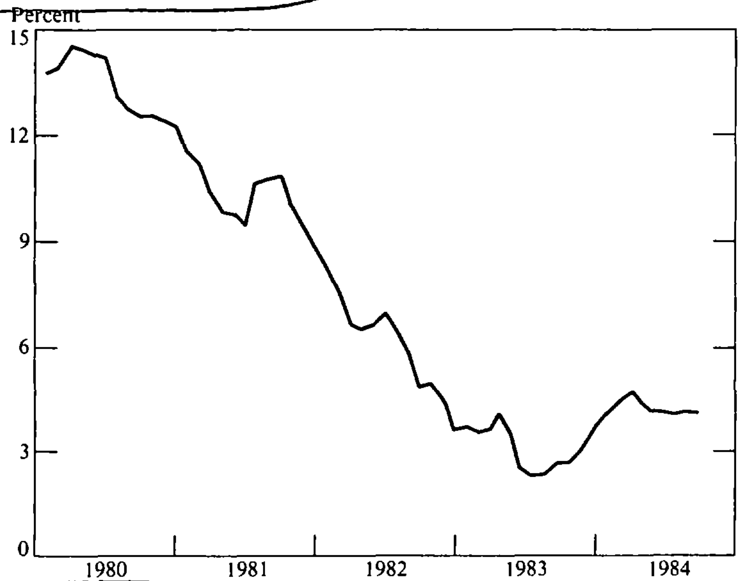


CHART 4

Change in average hourly earnings index

(percentage change from one year earlier)

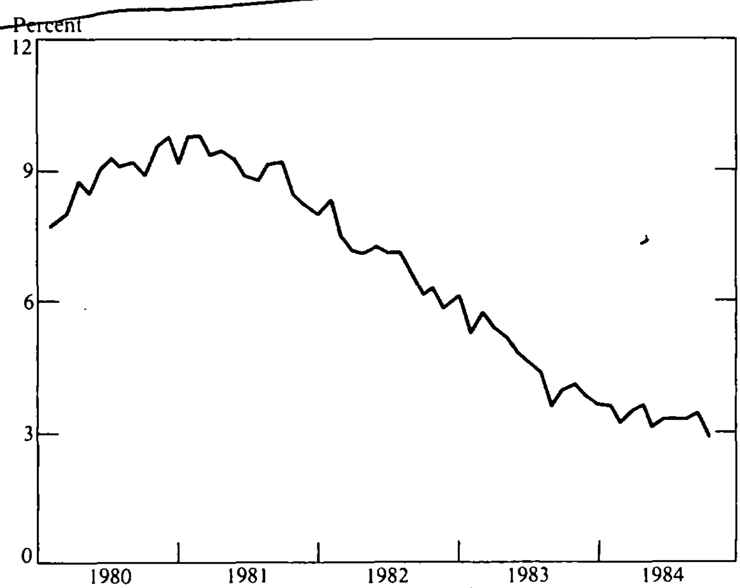
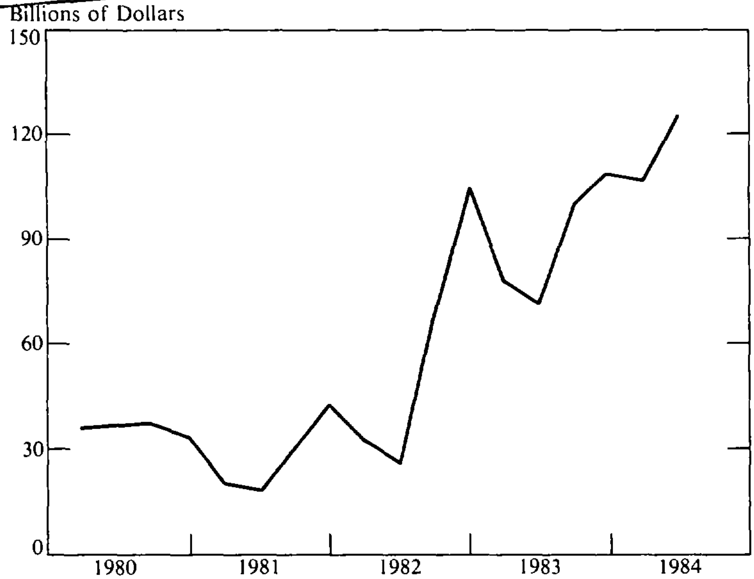


CHART 5
High employment budget deficit
(seasonally adjusted annual rate)



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faster in the third quarter and combined with a decline in productivity growth to give a further boost to growth in unit labor costs.

Factors influencing economic performance in 1984

Fiscal stimulus

While much of the recent discussion of the federal budget has focused on the potential impact of future deficits, the growing deficits of the recent past played an important role in the economy's rapid expansion in the first half of 1984. Reduced fiscal stimulus, on the other hand, may have played a role in the second-half slowdown.

Chart 5 shows the high employment deficit, a measure of fiscal stimulus. Movements in the direction of larger deficits indicate increased discretionary fiscal stimulus, while movements toward smaller deficits show reduced fiscal stimulus.

By this measure, the large increase in the high employment deficit in the last half of 1982 indicates a fiscal policy that was rapidly becoming more stimulative. This stimulus, due importantly to the Economic Recovery Tax Act of 1981 (ERTA), was a noticeable contributor to the continuing expansion of the economy in 1983 and the first half of 1984. As the chart shows, following an interruption to its continuing increase in the first half of 1983, fiscal stimulus in late 1983 resumed somewhat slower than in 1982. This moderation in the high employment deficit probably contributed somewhat to the slowing of economic activity since mid-1984.

Business fixed investment

Real business fixed investment (BFI), an important factor throughout this expansion, continued to contribute to the strong output growth in the first half of 1984. Following its surge to an average annual rate of 25 percent in the last half of 1983, investment growth slackened only slightly to a 21 percent annual rate in the first half of 1984. Real BFI's slower growth in the third quarter, while still strong at a 16 percent rate, did not match its earlier booming pace and thus provided less impetus to total growth after mid-1984.

Part of the purpose of ERTA was to stimulate business investment in new plant and equipment through significant reductions in business taxes. These business tax cuts permitted higher rates of return on new investment and undoubtedly contributed to the rapid growth in BFI in this expansion.

Domestic producers of investment goods have not garnered the full benefits of the boom in purchases of new plant and equipment. Import growth, much of it in the form of manufactured goods generally, has included a significant amount of investment goods, while exports of U.S. capital goods have been sluggish.

The dollar and net exports

More than investment goods production has been affected by the substantial rise in the value of the dollar since 1980 and the deterioration in the nation's net export position. Real net exports, which have fallen steadily since 1980, fell further in 1984 and were a serious drag on U.S. growth (Chart 2).

The rise in the value of the dollar has been responsible for much of the fall in net exports. Perception of the United States as a safe haven for funds, lower inflation in the United States than abroad, and higher real interest rates in the United States have all contributed to the strengthening of the dollar's value. The weighted average exchange value of the dollar weakened slightly in early 1984 and appreciated only a little more than 1 percent in the first half of the year, after an 11 percent increase in 1983 (Chart 6). The brief period of weakening of the dollar in early 1984 was neither large enough nor prolonged enough to turn U.S. trade around. The value of the dollar rose about 9 percent in the third quarter of 1984 and in early December was about 13 percent higher than at the end of 1983.

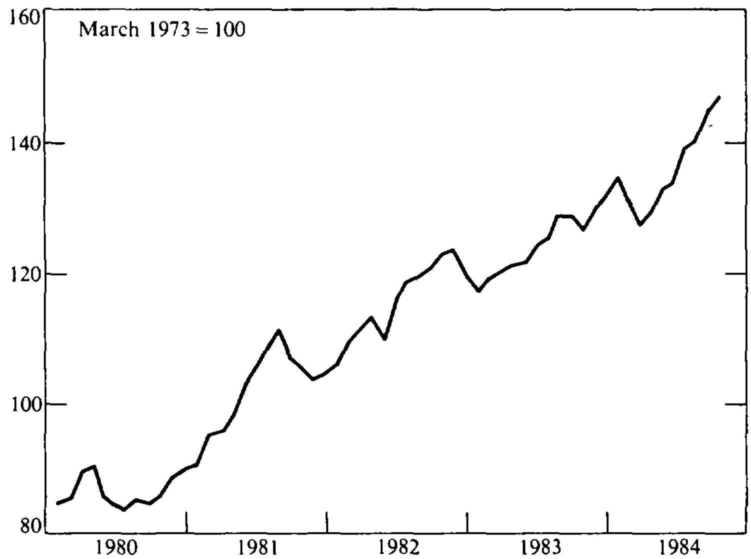
While weak foreign demand for U.S. output has been a drag on U.S. economic growth, the strong dollar has also brought increased imports into the country at lower prices. Lower import prices have helped restrain inflation in the United States, both directly and indirectly by helping hold down the prices of import-competing U.S. goods.

Labor costs and union settlements

Substantial slowing in increases in labor compensation also has contributed heavily to U.S. price disinflation. Wage disinflation occurred steadily through the fall of 1984 (Chart 4). Growth in unit labor costs also has slowed substantially, with rapid cyclical productivity growth and slow compensation growth both participating.

A significant part of the slowdown in compensation growth came from the unionized sector of the labor force. Negotiated wage concessions in several industries and subsequent lower negotiated contract settlements occurred in response to increasing foreign competition, stagnation in certain sectors of domestic business activity, and weak labor markets. As a result, average growth in compensation has recently slowed more for union

CHART 6
Weighted average exchange value of the U.S. dollar



workers than for nonunion workers (Table 1).

Negotiated wage rate changes under major collective bargaining settlements (those covering 1,000 or more workers) moderated in both the first half and the third quarter of 1984. Settlements in the first nine months covered 1.4 million workers and brought average wage adjustments of 2.5 percent for the new contract's first year and 2.8 percent a year over the life of the contract. These increases were considerably less than the adjustments made when the same parties bargained two or three years ago—8.6 percent and 7.2 percent, respectively.

TABLE 1
Employment cost index, private industry workers*
(percentage change for 12 months ending in June)

	Union	Nonunion
1980	10.2	8.7
1981	10.1	9.0
1982	8.1	6.5
1983	7.0	5.9
1984	4.9	5.7

*Changes in total compensation costs (wages, salaries, and employer costs for employee benefits), farm and household workers excluded.

Consumption

Total personal consumption expenditures (PCE)—benefiting from disinflation, lower interest rates, pent-up consumer demand, and gains in employment and income—played a major part in the rapid economic expansion of the first half of 1984. Durable goods purchases were especially strong, as housing and automobile sales reached peaks early in the year. Goods sales then hit the summer doldrums, and declines in consumer purchases of both durable and nondurable goods were important factors in the sharp third-quarter fall in GNP growth. Continued growth in spending for services kept total PCE growth positive, but the increase was less than 1 percent at an annual rate—a significant slowing factor for the economy since consumer spending is approximately two-thirds of total spending.

Financial developments and monetary policy

Financial developments largely mirrored developments in the economy in 1984. Interest rates rose in response to a strong economy in the first part of the year, then fell as the economy slowed in the third and fourth quarters. Similarly, relatively rapid monetary growth early in the year was followed after midyear by slower growth. Monetary policy actions generally paralleled economic and monetary developments in 1984, as the degree of reserve restraint tightened somewhat in the first part of the year and eased in the second part. These changes in the short-run stance of monetary policy reflected Federal Reserve efforts to bring about growth in the monetary aggregates consistent with low inflation and sustainable economic growth.

Interest rates

Interest rates fluctuated moderately in 1984, generally rising during the first half of the year and falling in the second half. At yearend, most interest rates were lower than a year earlier.

Short-term interest rates began rising in January 1984, continued on an upward trend through August, and then declined sharply during the latter part of the year. For example, the 3-month U.S. Treasury bill rate rose from around 9.0 percent in early January to over 10.5 percent in late August, then fell to around 8.4 percent by the first part of December (Chart 7).

Long-term interest rates also began increasing in January but peaked in June rather than in August. For example, average yields on 30-year U.S. government bonds rose from around 11.8 percent in early January to over 13.5 percent in the last week of June, then dropped to 11.6 percent by the first part of December (Chart 8).

Movement in interest rates, as noted earlier, closely paralleled developments in the economy. The strong economy in the year's first half was accompanied by a large increase in the demand for funds, which was a major factor in the first-half upward movement in interest rates. For example, reflecting in part the strong economy, total loans at the nation's commercial banks rose at a rapid annual rate of 15.9 percent during the first six months of the year, compared with 8.6 percent in 1983. By the same token, the economic slowdown that developed in the last half of the year was accompanied by slower growth in the demand for funds, with total loans at commercial banks rising only 9.7 percent at an annual rate from July through November. This drop in the demand for funds was the major factor in bringing about lower interest rates after midyear.

A second important factor in the interest rate picture in 1984 was the continued large demands placed on credit markets by the federal government's need to finance large budget

CHART 7
Selected short-term interest rates

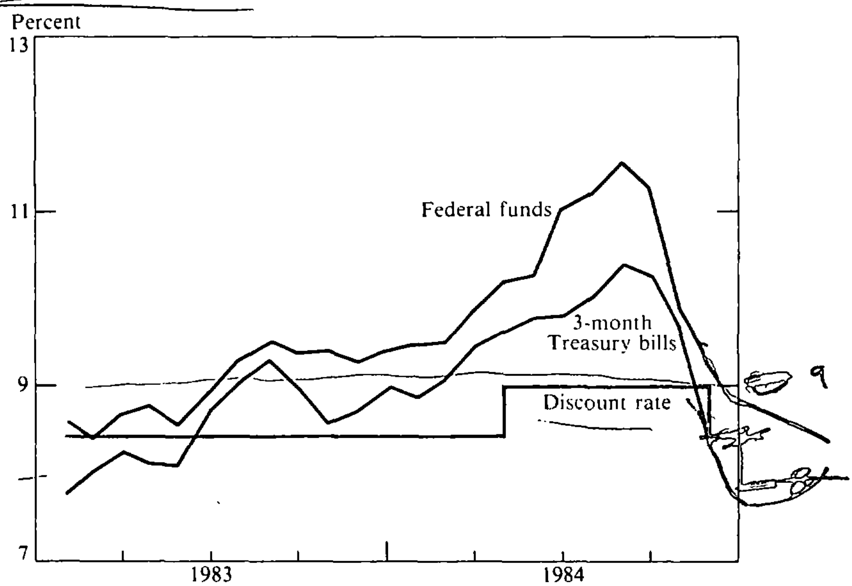
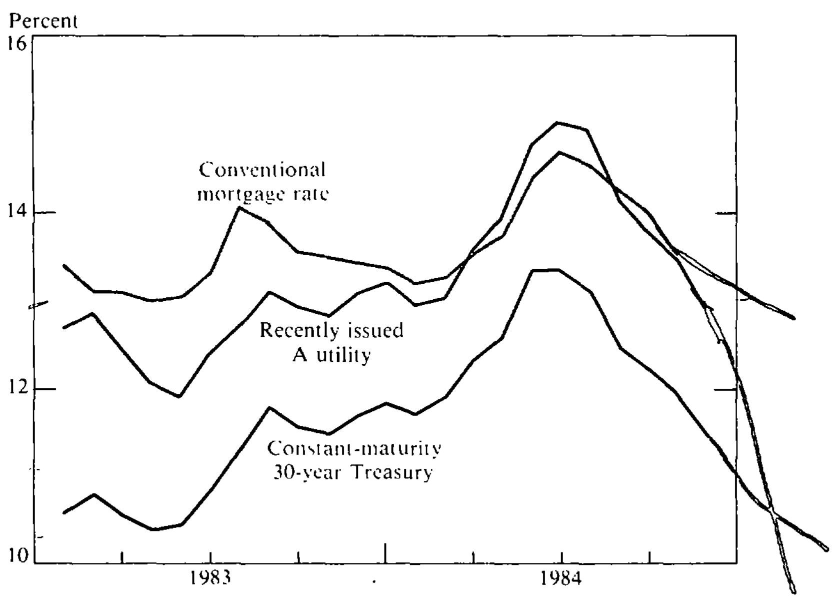


CHART 8
Selected long-term interest rates



deficits. In the first half of the year, this factor reinforced the upward pressure on interest rates emanating from the strong economy. Similarly, in the last part of the year, the continued large budget deficit partly countered the downward pressure on interest rates coming from the cooling economy, keeping interest rates from declining as much as they would have done otherwise.

The impact of the budget deficit can be seen by considering the behavior of real interest rates in 1984. The real interest rate, the nominal rate less the rate of inflation, represents the real cost of funds to borrowers, after adjustment for the decline in the burden of debt repayment caused by inflation. Real interest rates have remained at historically high levels in recent years. For example, the real prime interest rate rose sharply in 1980 and 1981 and has remained at a high level throughout the early 1980s (Table 2). The real prime rate declined in the latter part of 1984, reflecting the economic slowdown. In the fourth quarter, it averaged 8.1 percent, lower than in 1980 and 1981 but significantly higher than in the 1970s. The tendency for real interest rates to persist at high levels reflects to an important extent the impact of historically high budget deficits.

Monetary policy was a third factor affecting financial markets in 1984. A moderate firming in the degree of reserve restraint reinforced upward pressure on interest rates during the first part of the year, while an easing in the short-run policy stance supported the decline in rates in the latter part of the year.

TABLE 2
Nominal and measured real prime rates

Date	Nominal	Real
1970-74	7.5	1.5
1975-79	8.6	1.8
1979	12.7	4.7
1980	15.3	5.5
1981	18.9	10.2
1982	14.9	10.7
1983	10.8	7.1
1984	12.0	8.3
1984:Q1	11.1	6.7
Q2	12.3	9.0
Q3	13.0	9.3
Q4	11.8	8.1

Note: The measured real prime rate is defined in this table as the quarterly nominal prime rate minus the rate of inflation as measured by the percentage change at an annual rate in the GNP deflator. Data for the fourth quarter assumes that the prime rate averaged 11 percent in December and that the inflation rate equaled that of the third quarter.

Monetary aggregates

In line with the rapid economic growth of the first half of 1984, the nation's monetary aggregates grew fairly rapidly in the first and second quarters of the year. As the economy cooled after midyear, however, aggregate growth slowed, although growth apparently accelerated toward yearend.

For 1984 as a whole, M1 and M2 grew less rapidly than in 1983, while M3's growth was about the same in the two years. During the period from the fourth quarter of 1983 through November 1984, the narrowly defined money supply, M1, rose at a rate of 5.0 percent, sharply less than 1983's 10.0 percent growth (Table 3). The more broadly defined money supply, M2, rose at a rate of 7.5 percent during the first 11 months of 1984, also sharply less than in 1983, when M2 grew 12.1 percent. M3, a broadly defined money concept, rose at a rate of 10.0 percent during the fourth quarter 1983-November 1984 period, compared with 9.7 percent in 1983.

The slower growth in M1 and M2 in 1984 reflects rapid increases in the velocity or turn-

TABLE 3

Growth of the monetary aggregates: 1980-84

(percentage change at annual rates)

Period	M1	M2	M3	Domestic Non-financial Debt
1982	8.7	9.5	10.6	9.1
1983	10.0	12.1	9.7	10.8
1984: First 11 Months*	5.0	7.5	10.0	13.4
1984:Q1	7.2	6.9	8.9	12.9
Q2	6.2	6.9	10.3	13.1
Q3	4.5	6.2	8.2	12.7
Sept.	4.8	7.7	7.7	10.2
Oct.	-7.4	6.0	10.7	11.4
Nov.	8.6	14.9	15.9	14.2

Note: Annual rates of growth are based on quarterly average data. M1 is the sum of currency held by the public, plus travelers' checks, demand deposits, and other checkable deposits, including negotiable order of withdrawal (NOW and Super NOW) accounts, automatic transfer service (ATS) accounts, and credit union share draft accounts.

M2 is M1 plus savings and small-denomination time deposits, plus money market deposit accounts, shares in money market mutual funds (other than those restricted to institutional investors), and overnight repurchase agreements and certain Eurodollar deposits.

M3 is M2 plus large time deposits, large-denomination term repurchase agreements, and shares in money market mutual funds restricted to institutional investors.

Domestic nonfinancial sector debt is outstanding debt of domestic governmental units (federal, state, and local), households, and nonfinancial businesses.

*Fourth-quarter 1983 through November 1984.

over of money. For example, the velocity of M1 rose at a rate of 4.2 percent during the first three quarters of 1984, compared with a growth of 0.3 percent in 1983 and an average increase of 0.4 percent during the 1980-83 period. M2's velocity rose in the first three quarters of 1984 at a rate of 3.6 percent, in contrast with declines both in 1983 and during the 1980-83 period (Table 4). This greater increase in the velocity of money in 1984 indicates the public was economizing more on money balances than earlier. Due to this greater economizing, the public's demand for money grew less rapidly in 1984, and the slower growth in demand for money contributed to a slower monetary growth rate.

Monetary policy

Monetary policy continued to be guided in 1984 by the need to bring about moderate growth in the monetary aggregates consistent with continued long-run progress against inflation as well as continued growth in the econ-

TABLE 4
Growth of nominal GNP, M1, and velocity of M1 and M2

		Money Supply		Velocity	
Period	GNP	M1	M2	M1	M2
1970-79	16.0	8.9	15.4	3.8	0.2
1980-83	9.3	8.8	11.6	0.4	-0.6
1980	9.3	7.4	8.9	1.8	0.3
1981	10.7	5.2	9.3	5.2	1.2
1982	2.7	8.7	9.5	-5.5	-6.2
1983	10.4	10.0	12.1	0.3	-1.5
1984: First Three Quarters	10.2	6.1	6.8	4.2	3.6
1984:Q1	14.2	7.2	6.9	6.9	7.1
Q2	10.3	6.2	6.9	4.1	3.4
Q3	5.5	4.5	6.2	1.6	0.1

omy at a sustainable pace.

In seeking moderate monetary growth in 1984, the System's Federal Open Market Committee (FOMC) established growth rate ranges for the various monetary aggregates. For the period from the fourth quarter of 1983 to the fourth quarter of 1984, M1's growth rate range was established at 4 to 8 percent, while the ranges for M2 and M3 were both set at 6 to 9 percent. A range was also set for total domestic nonfinancial debt at 8 to 11 percent.[1]

As the FOMC implemented monetary policy during the first six months or so of 1984, the Committee acted to tighten somewhat the degree of restraint on bank reserve positions. This tightening in the short-run stance of policy was effected in response to greater than expected growth in the monetary aggregates, especially M1, in the context of greater than expected growth in the economy.

While monetary growth during the first six months of 1984 was broadly consistent with FOMC expectations and objectives, most of the monetary aggregates grew somewhat more rapidly than expected. For example, the FOMC expected M1 to grow at a rate of 7.0 percent during the December 1983-March 1984 period and at a rate of 6.5 percent during the March 1984-June 1984 period. As it turned out, M1 increased at a rate of 7.3 percent in the December-March period and 8.1 percent in the March-June period. While M2 grew somewhat less rapidly than expected in the first half of 1984, both M3 and domestic nonfinancial debt grew more rapidly than expected.[2]

Under the FOMC's operating procedures, this tendency for the monetary aggregates to

[1] *Record of Policy Actions of the Federal Open Market Committee*, meeting held on January 30-31, 1984, p. 17.

[2] For expected first-half monetary aggregate growth rates, see *Record of Policy Actions of the Federal Open Market Committee*, meetings held on January 30-31, 1984, March 26-27, 1984, and May 21-22, 1984.

grow more rapidly than expected would ordinarily be accompanied by a tightening in the short-run stance of monetary policy. Thus, the monetary policy directive issued following the March FOMC meeting, after stating that the Committee seeks to maintain pressures on bank reserve positions consistent with stipulated growth in the money supply, indicated that

> Greater restraint would be acceptable in the event of more substantial growth of the monetary aggregates, while somewhat lesser restraint might be acceptable if growth of the monetary aggregates slowed significantly. . . .[3]

The short-run stance in monetary policy, however, is not automatically altered when the money supply grows more or less rapidly than expected. Other factors are considered. For example, in the above directive, the FOMC stated that a change in the degree of reserve pressure in response to the emergence of unexpectedly high or low monetary growth

> . . . would be considered in the context of appraisals of the continuing strength of the business expansion, inflationary pressures, and the rate of credit growth.[4]

Thus, in making changes in the short-run stance of policy in 1984, the Federal Reserve evaluated the behavior of the money supply in the context of other developments, such as the course of the economy and inflation.

As was noted, the economy grew rapidly during the first half of 1984. In fact, economic growth was much greater than the FOMC expected. The FOMC members expected the economy to continue expanding in 1984, although at a slower rate than in 1983. For the period from the fourth quarter of 1983 through the fourth quarter of 1984, FOMC members expected real GNP to increase between 3.5 and 5.0 percent.[5] In the first half of 1984, though, real GNP grew at a rate of 8.5 percent.

The stronger than expected economic growth provided the appropriate context for responding to relatively rapid monetary growth by firming the short-run stance of policy. As a result, the pressure on bank reserve positions was tightened some. This tightening was accompanied by an increase in adjustment plus seasonal borrowing at the discount window from an average of $712 million in January to $974 million in August, while the federal funds rate rose from an average of 9.6 percent in January to 11.6 percent in August.[6] Also, the discount rate was increased from 8.5 percent to 9.0 percent on April 9, 1984.

During the latter part of 1984, the FOMC acted to reduce the restraint on bank reserve positions. This easing in the short-run policy stance was in response to sluggish growth in the monetary aggregates, in the context of the economic slowdown.

In general, the money supply grew much less rapidly than expected during the last half

[3] *Record of Policy Actions of the Federal Open Market Committee*, meeting held on March 26-27, 1984, p. 13.

[4] *Record of Policy Actions of the Federal Open Market Committee*, meeting held on March 26-27, 1984, p. 13.

[5] *Record of Policy Actions of the Federal Open Market Committee*, meeting held on January 30-31, 1984, p. 7.

[6] Adjustment plus seasonal borrowing was considerably higher than the August level in the April-June period due mainly to borrowing by a bank having liquidity problems. Later, borrowing by this bank was classified as extended rather than adjustment borrowing. Also, the federal funds rate rose more during the January-August period than normal, given the relatively small increase over the seven-month period in adjustment plus seasonal borrowing. The relatively large increase in the funds rate was due to a greater than normal reluctance on the part of some banks to borrow at the discount window that developed over the late spring and summer months.

of the year. For example, M1 was expected to grow at a rate of 5.5 percent during the June 1984-September 1984 period and at a rate of 6.0 percent during the September 1984-December 1984 period.[7] During the five months ending in November, however, M1 grew at a rate of only 1.4 percent.

As the economic growth rate slowed the second half of the year, the Federal Reserve responded to this weakness in the money supply and the economy by bringing about an easing in the stance of policy. The Record of Policy Actions for the meeting held on October 2 notes:

> Against the background of monetary growth that was weaker than anticipated, indications of a slowing in the pace of economic advance, and a rapidly rising dollar in foreign exchange markets, open market operations were conducted, as the intermeeting period [the period between the August 21 meeting and the October 2 meeting] progressed, so as to lessen pressures on bank reserve positions.[8]

The record goes on to say that adjustment plus seasonal borrowing declined between meetings and the easing in bank reserve positions was reflected in a decline in the federal funds rate.

Further declines in borrowing and the federal funds rate developed after the October FOMC meeting. During the four weeks that ended December 5, the level of borrowing declined to $675 million, compared with $974 million in August. The federal funds rate declined to around 8.8 percent in the first week of December, compared with around 11.8 percent at the end of August. On November 21, 1984, the discount rate was lowered from 9 percent to 8.5 percent.

As the Federal Reserve altered its short-run policy stance in 1984 in response to the monetary and economic developments, the growth rates of M1 and M2 for the year as a whole remained within their established growth rate ranges. The growth rate of M1 through November 1984 was moderately below the midpoint of its FOMC range. M2's 11-month growth rate was at the midpoint of its range, while M3's growth rate was above the upper end of its range. For the period from the fourth quarter of 1983 through October 1984, the growth rate of total domestic nonfinancial debt also exceeded its 1984 growth rate range (Table 5).

The outlook for 1985

The factors important in the economy in 1984 are likely to continue to play significant roles in 1985. Increases in the high employment deficit are expected to be moderate in the near term, implying only moderate additional fiscal stimulus. Some modest weakening in the dollar's value is still expected, but not enough to affect net exports significantly or to relax the dollar's downward pressure on U.S. prices. With a rapidly rising factory use rate no longer in evidence, the pressure for increased business fixed investment has been lessened. According to survey results, businesses intend to increase their purchases of new plant and equipment by about 4 percent in 1985, following an estimated 13 percent increase in 1984—both in real terms. Consumers appear to be fairly con-

[7] For expected second-half monetary aggregate growth rates, see *Record of Policy Actions of the Federal Open Market Committee*, meetings held on July 16-17, 1984, August 21, 1984, and October 2, 1984. At the August 21 meeting, the expected growth of M1 for the June-September period was revised to 5 percent.

[8] *Record of Policy Actions of the Federal Open Market Committee*, meeting held on October 2, 1984, p. 5.

TABLE 5
Growth of the monetary aggregates
(seasonally adjusted annual rates)

Period	M1	M2	M3	Domestic Non-financial Debt
1984 Actual*	5.0	7.5	10.0	13.4
1984 FOMC Growth Ranges	4-8	6-9	6-9	8-11

*Growth rate from fourth-quarter 1983 through November 1984.

fident and reasonably liquid, which should combine with expected income growth to provide moderate growth in consumer spending. With little, if any, further tightening in labor markets expected, only modest pressures of rising labor costs on prices are expected.

Given these factors, the pace of economic expansion is likely to remain moderate in 1985. Real GNP is expected to grow in the neighborhood of 3 percent for 1985, somewhat more than in 1984's last half but lower than in 1984 as a whole.[9] Inventory investment will probably contribute little if anything to total output growth. Among final demand sectors, government purchases, especially defense purchases, should support growth, as should consumer expenditure growth at a somewhat more rapid pace than in late 1984. Growth in business fixed investment will be an important contributor to total economic activity, but plant and equipment spending growth will be well below the pace of 1984. Residential construction is likely to provide only minor support to overall growth. Finally, net exports are expected to continue to be a drag on GNP growth, even if the dollar weakens modestly, as is widely expected.

Real GNP expansion in 1985 at the expected 3 percent pace, which is near the economy's long-run trend growth rate, will allow little further reduction in unused resources. The overall unemployment rate and the capacity use rate in manufacturing may be expected to improve only slightly, at best, through 1985.

The rate of inflation is likely to increase moderately as the expansion continues. Further increases in compensation growth can be expected to combine with a slowing of productivity growth from its recent cyclical surge to bring somewhat more rapid growth in labor costs and an associated upward pressure on prices. Overall, inflation should continue to benefit from a relatively favorable behavior of food and energy prices. While the effect of a sharp and large decline in the value of the dollar is perhaps the greatest risk to continued moderate inflation, such a decline is not generally expected.

Monetary policy in 1985 will continue to seek moderate growth in the monetary aggregates and tentative growth rate ranges for 1985 were established at the July 1984 FOMC meeting. In line with the goal of further progress

[9] A 3 percent real GNP growth, from the fourth quarter of 1984 through the fourth quarter of 1985, is consistent with the midpoint of the range projected by the members of the Federal Open Market Committee. See the transcript of the Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Joint Economic Committee, July 30, 1984.

over time in reducing inflation, these tentative ranges were set somewhat lower than the 1984 ranges. M1's tentative growth rate range for the period from the fourth quarter of 1984 through the fourth quarter of 1985 was set at 4 to 7 percent, slightly less than the 1984 range of 4 to 8 percent. M2's tentative 1985 range is also lower, 6 to 8.5 percent, compared with 6 to 9 percent in 1984. The tentative 1985 range for M3 is 6 to 9 percent, the same as in 1984. Also, the tentative range for domestic nonfinancial debt was set at the 1984 range of 8 to 11 percent. These tentative growth rate ranges will be updated when the FOMC meets in early 1985.

In conducting monetary policy in 1985, it is likely that the Federal Reserve will continue to be guided by the behavior of the monetary aggregates relative to the growth rate ranges. The need for policy actions due to any emergence of unexpectedly high or low monetary growth is likely to be evaluated in the context of broader economic and financial developments, as was the case in 1984. Under these circumstances, the course of interest rates in 1985 will reflect developments in the economy and with regard to inflation and the federal budget deficit. Given the outlook for moderate economic growth and continued low inflation in 1985, the outlook for interest rates depends heavily on budget developments. If no progress is made in reducing the large deficits, interest rates may tend to firm if, as expected, economic activity accelerates from the sluggish pace of late 1984. On the other hand, significant progress in reducing the budget deficit in 1985 could be expected to alleviate credit market pressures and set the stage for a sustainable decline in real interest rates that would support good economic performance in 1985 and beyond.