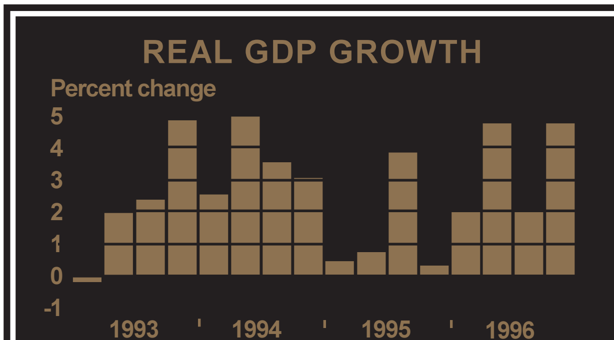
Monetary Policy

The Federal Reserve conducted monetary policy in 1996 to promote sustainable economic growth and progress toward price stability. Early in the year, policy was eased slightly in response to signs of a slowing economy and subdued inflationary pressures. Policy was unchanged over the rest of the year as economic growth returned to a more robust pace, and inflation remained moderate.



The economy rebounded quickly in early 1996 partly in response to monetary easing, posted an exceptionally strong second quarter, and duplicated that strong showing late in the year.

Concern about slower economic growth was widespread in early 1996. The economy was lackluster in late 1995 and still appeared sluggish at the beginning of 1996. With severe weather plaguing much of the country, industrial production and employment fell in January. The slower growth reduced concerns about inflationary pressures. In response to moderating growth and the improved inflation outlook, the Federal Reserve continued the easing of monetary conditions begun in late 1995. The discount rate was reduced from 5¼ percent to 5 percent in January 1996, and the Federal Open Market Committee (FOMC) decided the reduction should be fully reflected in the federal funds rate, which fell from about 5½ percent to 5¼ percent.

Buoyed in part by the monetary easings in late 1995 and early 1996, the economy quickly rebounded. Economic indicators such as employment showed sizable gains in February and March. With this pickup in growth offsetting the January slowing, real economic activity advanced at a 2 percent rate in the first quarter. Lower interest rates in late 1995 and early 1996 helped to boost spending on durable consumer goods, business equipment, and housing. But a deterioration of the trade balance and a fall in inventories held back economic growth. The automotive sector accounted for most of the inventory correction, as the industry worked off the excessive inventories accumulated in late 1995.

The economy accelerated sharply in the second quarter of 1996. Real economic activity grew at a 4.7 percent rate, led by government expenditures, consumer spending on durable goods, business equipment investment, and residential construction. The surge in government spending reflected a return of federal expenditures to normal levels following the government shutdowns of late 1995 and early 1996. Expenditures on consumer durables and housing were strengthened by faster job growth and rising consumer confidence. A decline in the trade balance again held back the economy, although a pickup in exports made the trade balance less of a drag on growth than in the first quarter.

The brisk growth of the first half of 1996 was accompanied by moderate inflation. Higher food and energy prices pushed inflation in the overall consumer price index (CPI) up from 2.7 percent in 1995 to a 3.5 percent rate in the first half of last year. But the core CPI, which excludes food and energy prices, advanced at a 2.8 percent annual rate, down slightly from the 3 percent pace in 1995. The pace of expansion kept labor markets tight, however, exerting some upward pressure on wages and salaries. Because the economy was growing robustly and inflation pressures were moderate in the first half of the year, the FOMC left monetary policy unchanged after the January easing.

The economy continued to grow at a healthy pace in the second half of the year. In the third quarter, real economic activity grew at a moderate 2.1 percent annual rate, as somewhat higher market interest rates and slower income growth reined in spending. Economic growth also slowed because government spending returned to the downward trend of recent years. Business equipment spending remained a source of strength in the third quarter, and firms replenished their inventories in anticipation of further growth. The economy accelerated in the fourth quarter, propelled by faster growth in consumer spending and a surge in exports.

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While the economy expanded solidly in the latter half of 1996, inflationary pressures remained subdued. The pace of expansion was strong enough to reduce the unemployment rate to 5.2 percent in August, matching the lowest rate of the 1990s. Although the labor market tightness generated some upward pressure on wages, broad measures of consumer price inflation declined. Overall CPI inflation slowed to 3 percent in the second half of the year, and core CPI inflation slowed to 2.4 percent. With the economy growing at a solid pace and inflation subdued, monetary policy was unchanged in the second half of 1996.

Overall, the economy was very healthy in 1996. After a slow start, real economic activity expanded at a robust pace and consumer price inflation was moderate. The Federal Reserve sought to adjust monetary policy so as to promote these favorable conditions. Policy was eased early in 1996 when the economy slowed, and was unchanged over the rest of the year as economic growth resumed a stronger pace and inflation pressures remained subdued.