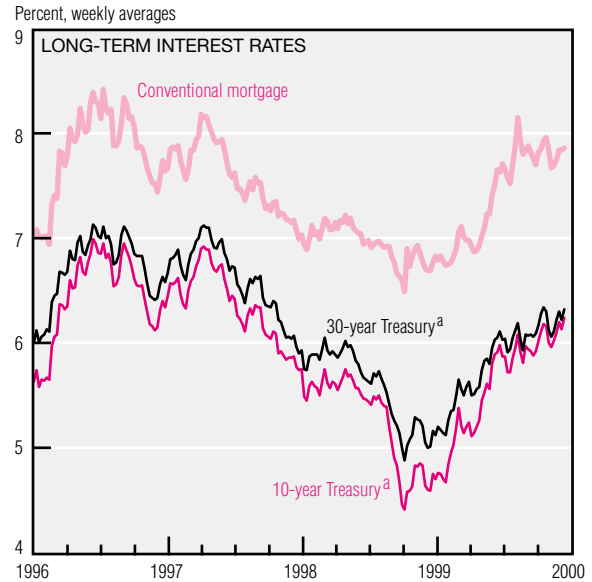
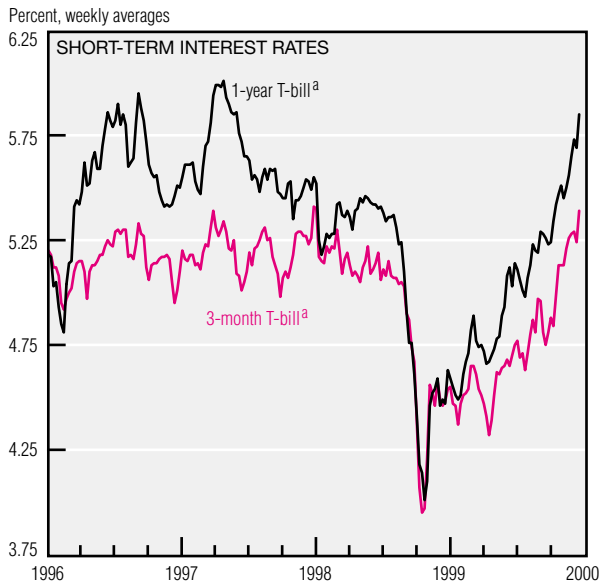
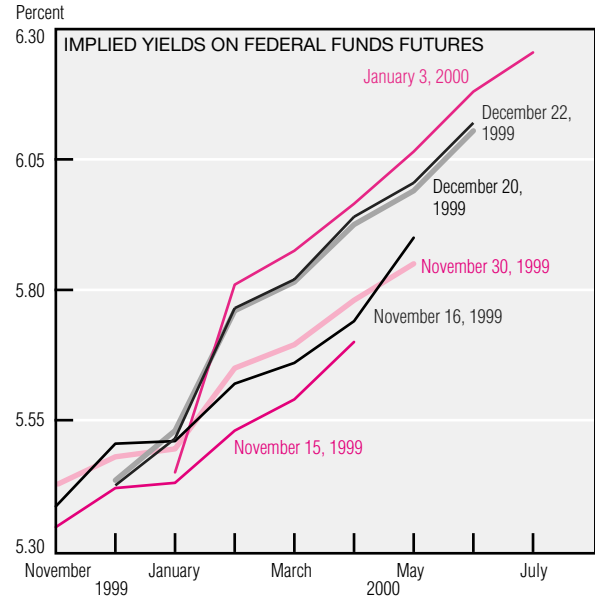
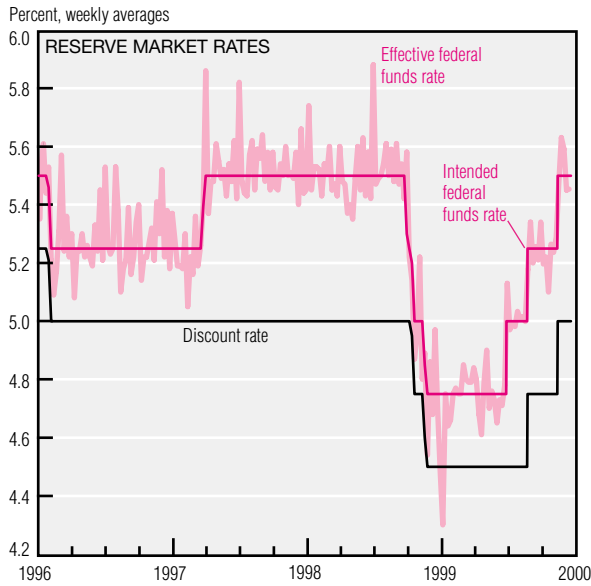


# Monetary Policy



a. Constant maturity.

SOURCES: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

The Federal Open Market Committee left the 5.5% intended federal funds rate unchanged at its December 21 meeting, citing the need for “a smooth transition into the Year 2000.” Although the FOMC adopted a symmetric directive, its press release expressed concern about persistent increases in demand that could eventually lead to inflationary imbalances, “even after taking account of the remarkable rise in productivity growth.” Because such imbalances could undermine the

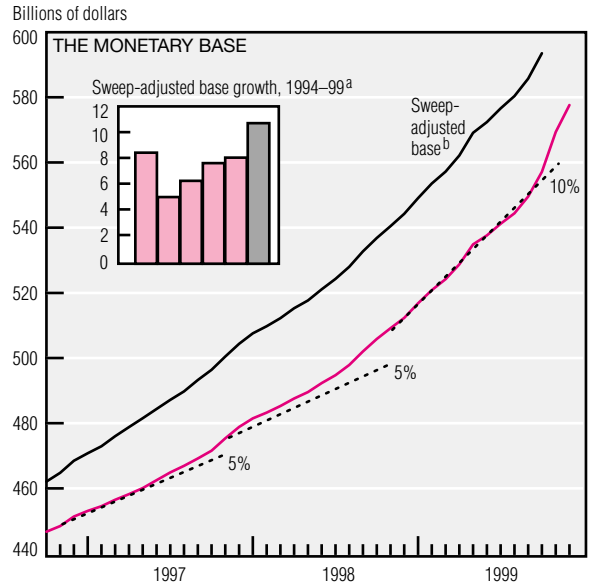
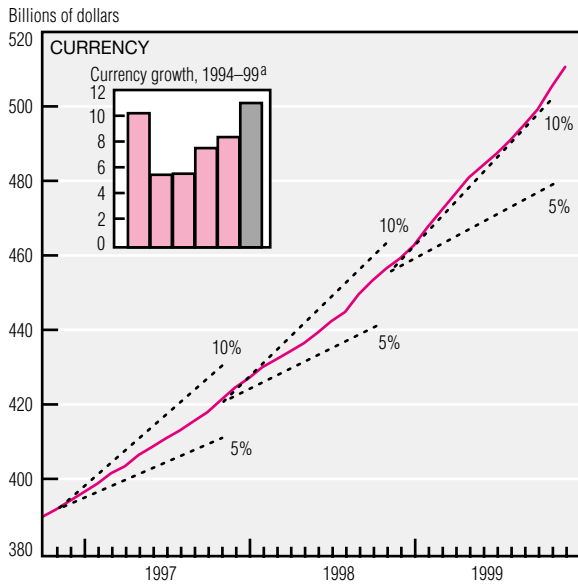
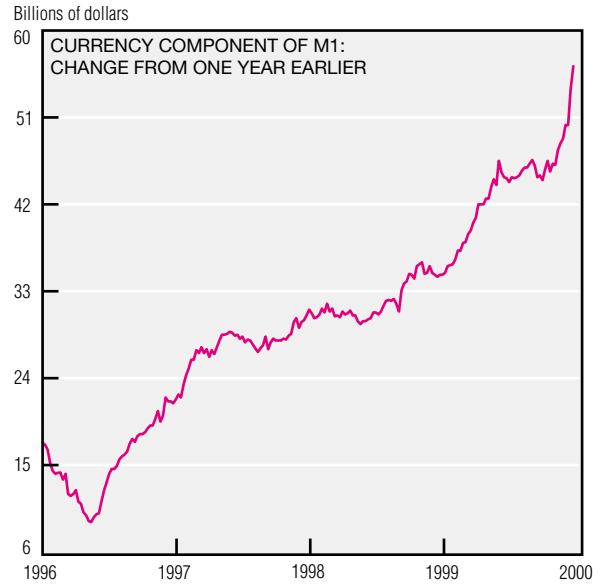
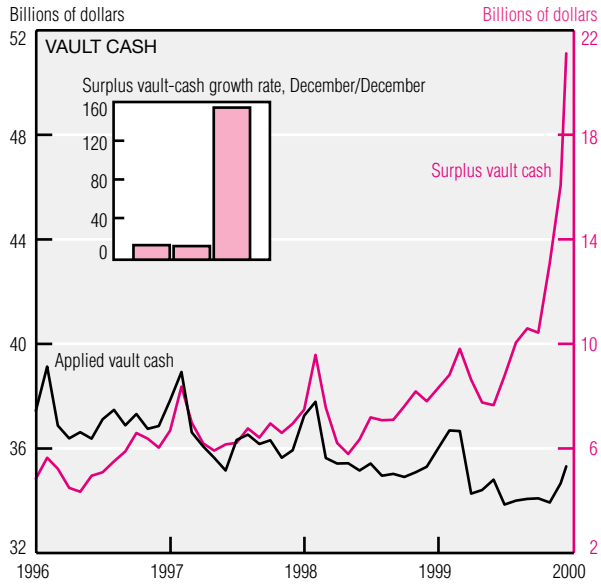
economy’s exemplary performance, the Committee noted that it “will assess additional information on the balance of supply and demand, and the possible need for adjustment in the stance of policy to contain inflationary pressures.”

Implied yields on federal funds futures contracts are a popular indicator of the expected future path of policy. By these measures, market participants clearly did not expect any change in the intended federal funds rate at the December meeting.

However, recent futures pricing reveals high odds for an increase of 25 basis points (bp) at the February 2000 meeting and at least one more 25-bp increase by June.

Short-term interest rates continue to exhibit a strong upward trend, reflecting the three 25-bp increases in the intended federal funds rate in 1999. These actions essentially retraced the three funds-rate reductions in the fall of 1998, taken to ensure adequate liquidity in that period  
(continued on next page)

# Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a four-quarter over fourth-quarter basis. The 1999 growth rates for currency and the monetary base are calculated on an estimated December over 1998:IVQ basis.  
 b. The sweep-adjusted base contains an estimate of balances temporarily moved from M1 to non-M1 accounts.  
 NOTE: Data are seasonally adjusted. Last plots for currency and the monetary base are estimated for November 1999. Last plot for the sweep-adjusted base is September 1999. Dotted lines represent growth rates and are for reference only. Plots for surplus and applied vault cash include data through December 15, 1999.  
 SOURCE: Board of Governors of the Federal Reserve System.

of financial stress. The 3-month Treasury-bill rate reached 5.39%, up 81 bp for 1999. Likewise, the 1-year Treasury climbed to 5.85%, up 126 bp (1.25%) for the year.

Currency held by the banking sector increased substantially during recent months in anticipation of heightened millennial demand. Surplus vault cash, that is, currency held in excess of reserve requirements, accounted for virtually all of the increase. Seasonal fluctuations associated with holiday shopping routinely raise applied vault cash

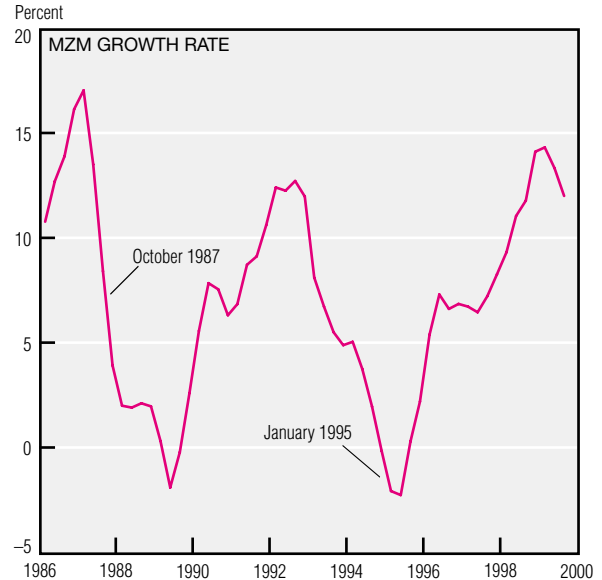
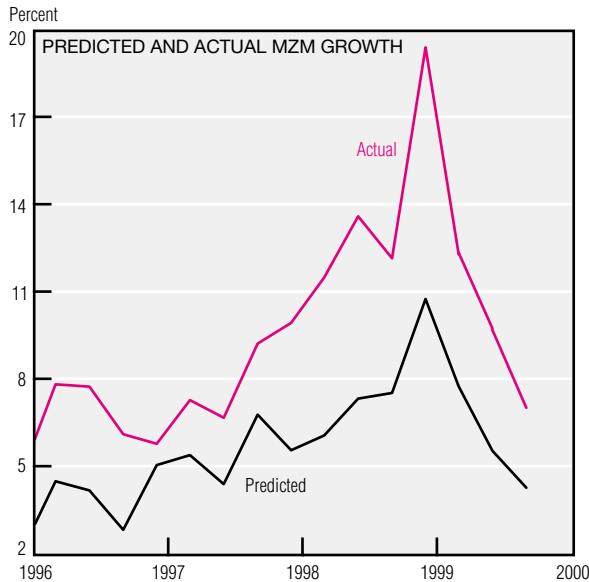
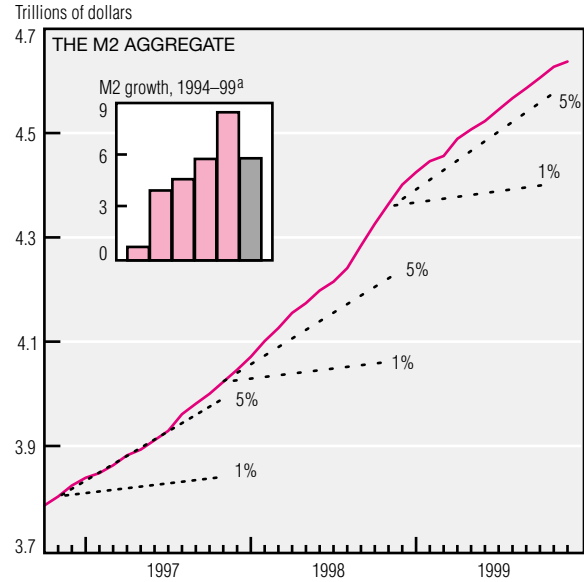
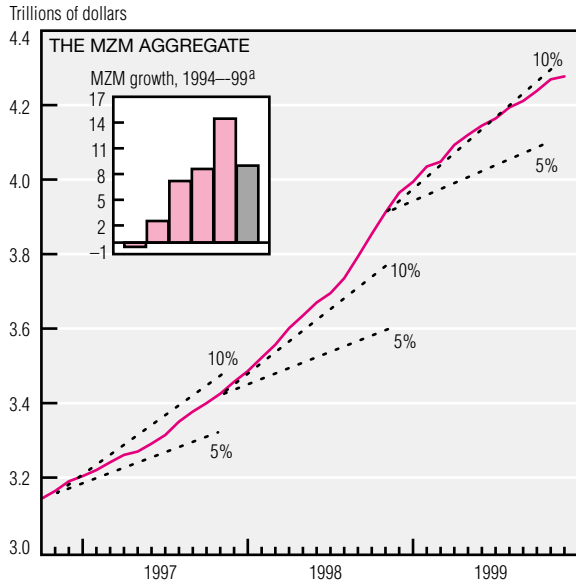
and increase surplus holdings by 30%–50%. On December 29, 1999, surplus vault cash was almost two-and-a-half times the average level of holdings recorded throughout much of the year. Although disruptions associated with the century date change were expected to be small, the Federal Reserve System, in conjunction with the U.S. Treasury, worked to ensure that currency would be on hand to meet any potential demand.

Not surprisingly, growth rates accelerated recently for the currency component of M1 (currency

held by the nonbank public) and the monetary base (currency plus total reserves). Currency and monetary base growth averaged around 10% through October. As of the second week in December, currency growth had increased to 11%, while monetary base growth had increased to 13%. The limited size of the increase in currency held by the nonbank public may have reflected confidence in the Federal Reserve's commitment and ability to supply liquidity.

*(continued on next page)*

## Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 1999 growth rates for MZM and M2 are calculated on an estimated December over 1998:IVQ basis.

NOTE: Data are seasonally adjusted. Last plots for MZM and M2 are estimated for December 1999. Dotted lines for M2 are FOMC-determined provisional ranges. All other dotted lines represent growth in levels and are for reference only.

SOURCES: Board of Governors of the Federal Reserve System; and Federal Reserve Bank of Cleveland.

Because the public's Y2K concerns centered mainly on the potential for payment system interruptions, they were reflected primarily in increased currency holdings, with no apparent impact on the larger monetary aggregates. By contrast, in region-specific financial crises, like those surrounding the 1998 Russian default, investors worry mainly about potential capital loss associated with assets denominated in the region's currency. Fleeing capital typically seeks a temporary safe haven for funds. The Russian default, for example, sharply increased

demand for relatively safe securities such as U.S. Treasury instruments, money market mutual funds denominated in dollars, and, to a lesser extent, deposits at U.S. commercial banks.

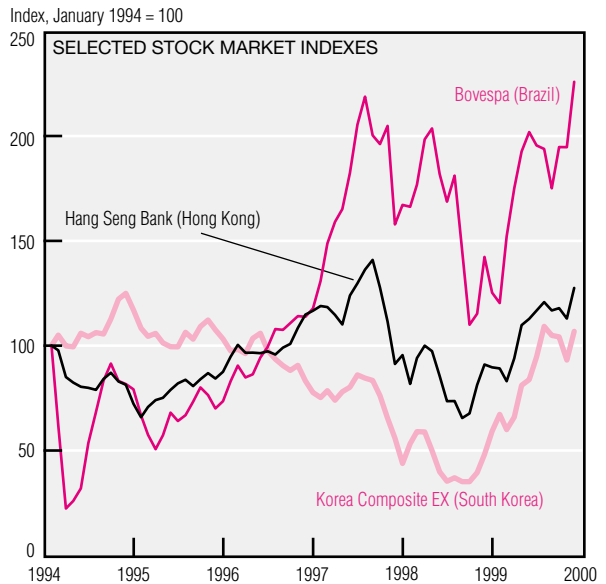
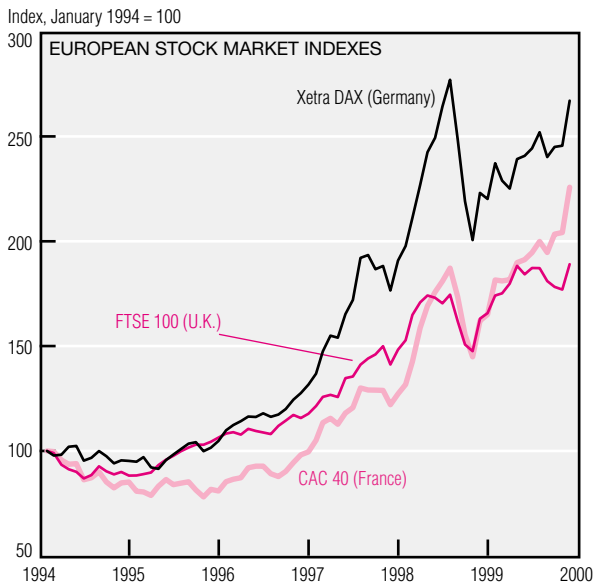
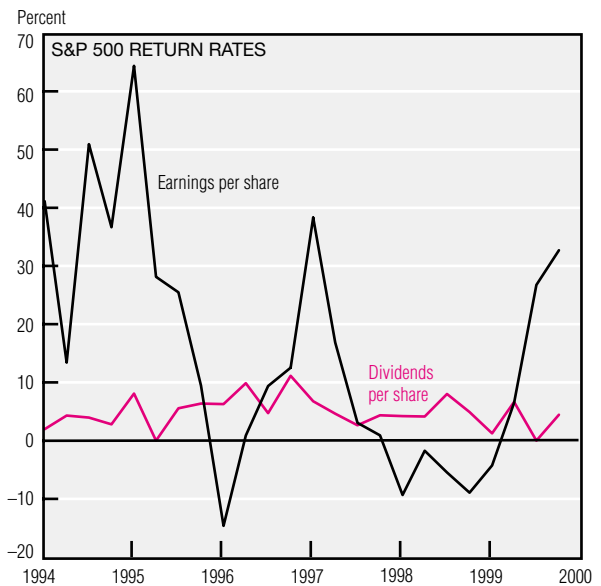
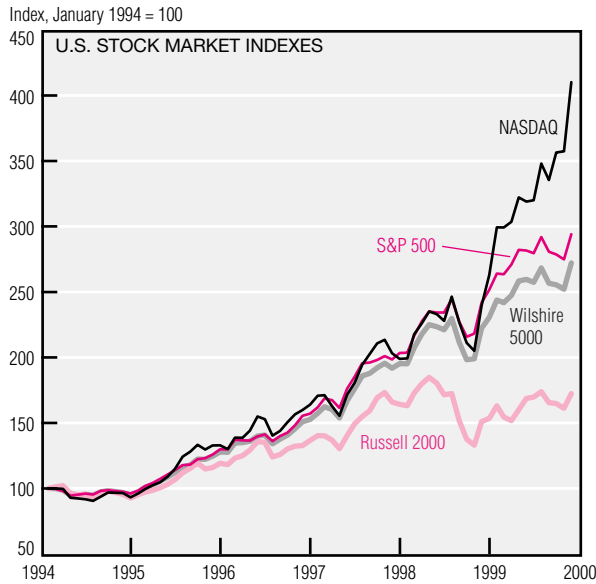
In late 1998, swelling U.S. demand for money funds and commercial bank deposits was mirrored in growth rates for MZM and M2, the monetary aggregate measures. MZM growth, especially, surged relative to the rate that might have been expected, given income and interest rates. Although MZM growth declined once conditions

stabilized, it remained above the level predicted by the standard model. Some market commentators believe that the retained liquidity may have been held as insurance in case of Y2K problems.

Historically, swings in liquidity's growth rate (as measured by MZM) have been substantial over periods of several years. Moreover, persistent sharp declines in MZM growth have been associated with stock market corrections. In light of the 1999 turnaround in MZM growth, the same commentators have begun

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## Monetary Policy (cont.)



SOURCES: Standard & Poor's Corporation; *Wall Street Journal*; and *Financial Times*.

suggesting that it is necessary to monitor liquidity measures.

Despite slower MZM growth, equity-market exuberance continued through year's end. Earnings growth for large firms remains strong. Earnings per share of S&P 500 companies, for instance, increased at double-digit rates through the first three quarters of 1999.

It is important to note, however, that not all boats have risen with the tide. Stock indexes were pushed to record levels largely by a boom in the so-called tech stocks, which are primarily traded on the NASDAQ exchange, whose composite increased

85.6% in 1999. Tech stocks reportedly accounted for 88% of the annual increase in the S&P 500. Indeed, prices for the majority of stocks traded on the New York Stock Exchange declined from their levels one year earlier. Although the Russell 2000 Index, comprised of firms with small market capitalization, increased in 1999, it did not recover to its prior peak of spring 1998.

The confidence exuded by U.S. equity markets in recent years spread to other parts of the world in 1999. European stock prices have surged in the last few months. Germany's DAX exchange, for example, in-

creased more than 30% on the year and stood above the peak it reached before the 1998 Russian default. Equity prices in Hong Kong and Korea increased substantially on the year, but remained near their peaks prior to the Asian crises. Brazil's Bovespa Index more than doubled this past year. Thus far, investor confidence has been reinforced by economic good news, especially about U.S. productivity. However, just as one cannot know if investors are irrationally exuberant, one cannot know if a sudden drop in investor confidence is just around the corner. Such events are evident only in retrospect.