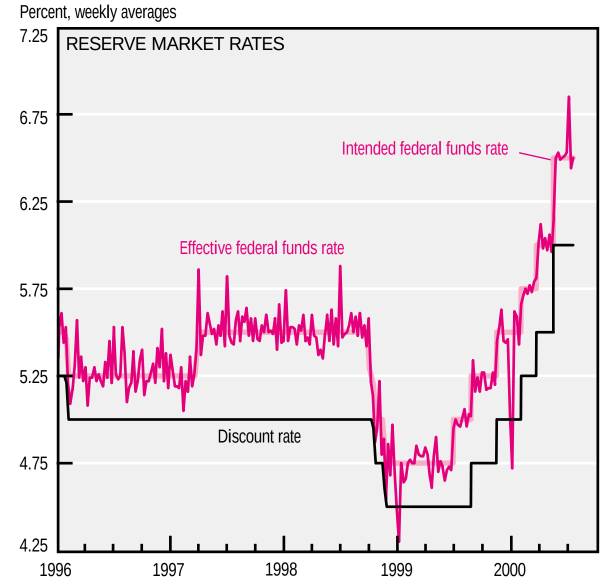
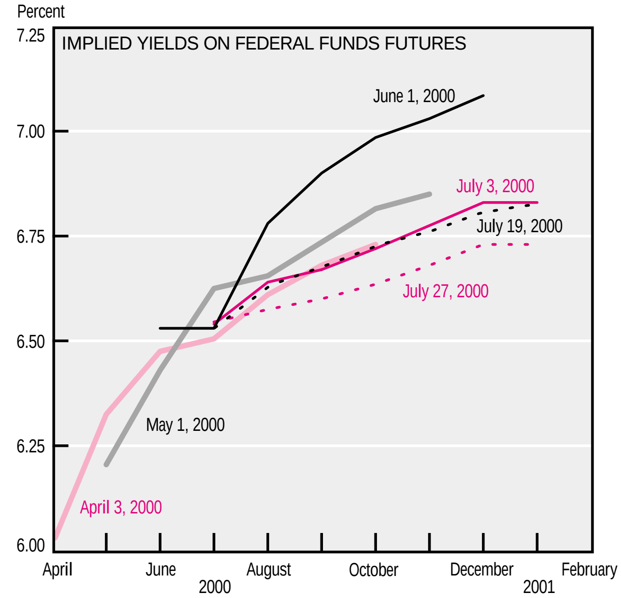
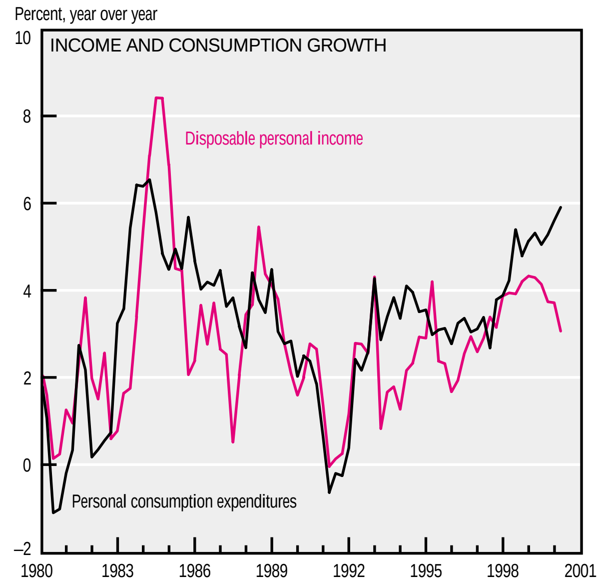
Monetary Policy





Economic Projections, 2000 and 2001 (percent)[a]

	Federal Reserve governors and Reserve Bank presidents: Range	Federal Reserve governors and Reserve Bank presidents: Central tendency	Administration
2000			
Nominal GDP	6.00–7.25	6.25–6.75	6.0
Real GDP[b]	3.75–5.00	4.00–4.50	3.9
PCE prices	2.00–2.75	2.50–2.75	3.2
Civilian unemployment	4.00–4.25	About 4	4.1[c]
2001			
Nominal GDP	5.00–6.25	5.50–6.00	5.3
Real GDP[b]	2.50–4.00	3.25–3.75	3.2
PCE prices	1.75–3.00	2.00–2.50	2.5
Civilian unemployment	4.00–4.50	4.00–4.25	4.2[c]



a. Civilian unemployment rate projection is the average level for the fourth quarter. All other projections are percent changes, fourth quarter over fourth quarter.
b. Chain-weighted.
c. Projection is for the Consumer Price Index.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, Monetary Policy Report to the Congress; and Chicago Board of Trade.

After the Federal Open Market Committee (FOMC) decided in June to leave the intended federal funds rate unchanged, and a subsequent data release showed that the economy may be slowing, market participants lowered their expectation that the rate would be increased at the FOMC's August 22 meeting. On June 1, the August contract was trading 28 basis points (bp) above the current federal funds target rate of 6.5%, indicating that market participants considered a rate increase likely. By July 3, the implied yield on the August contract had dropped to 6.64%, 14 bp above the target rate; it hovered near there until July 20, when FOMC Chairman Alan Greenspan appeared before Congress. As of July 27, the August contract was trading at 6.58%, only 8 bp above the target rate.

In past years, Chairman Greenspan has appeared before Congress every February and July to testify on the state of the American economy and the outlook for monetary policy, as mandated by the Full Employment and Balanced Growth Act of 1978. That legislation (also called the Humphrey–Hawkins Act, after its sponsors) has expired; however, Mr. Greenspan continues to provide biannual briefings and the Board of Governors' Monetary Policy Report to the Congress. The first such briefing since the expiration of Humphrey–Hawkins occurred, much as before, on July 20.

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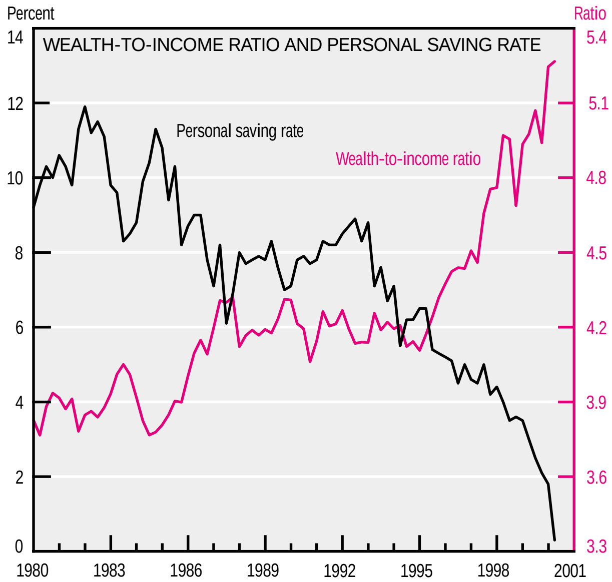

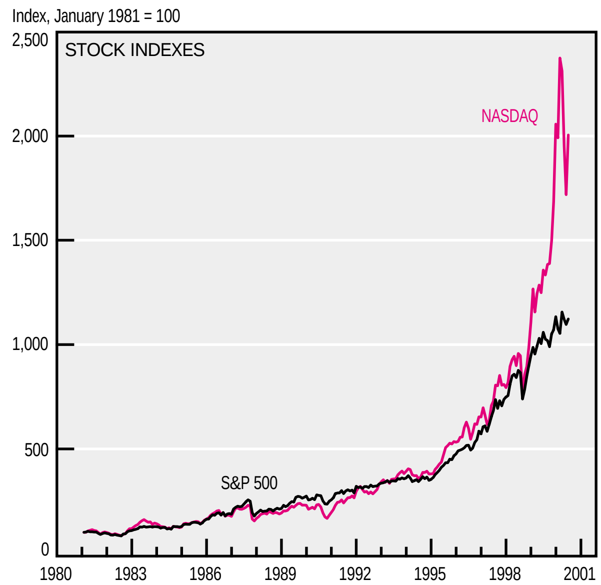

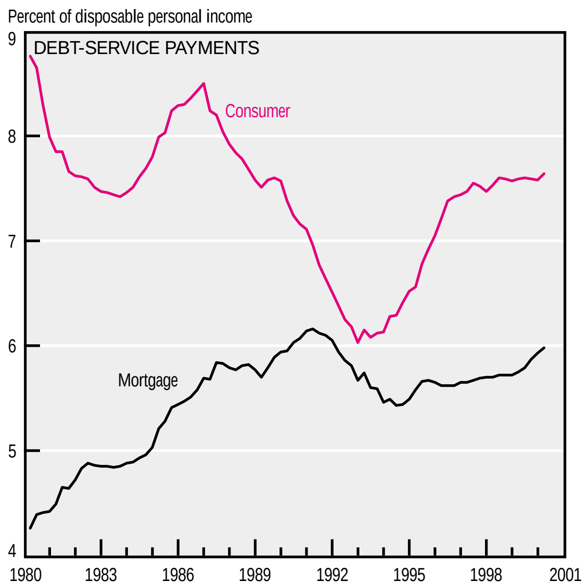

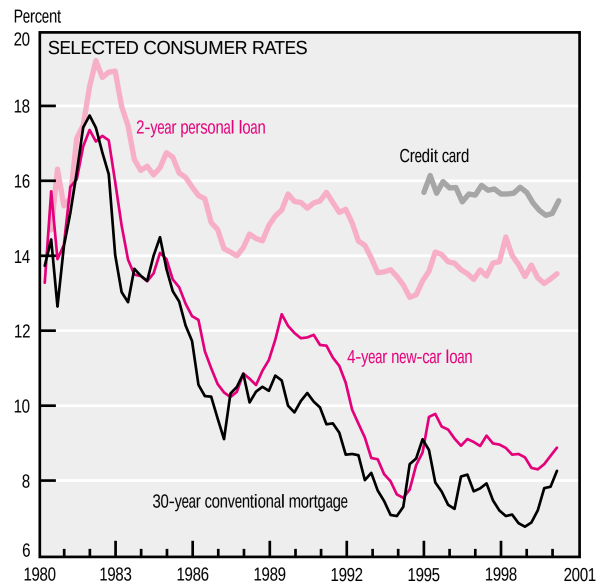

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and Haver Analytics.

The report contains the Board of Governors' and Federal Reserve Bank presidents' economic projections for 2000 and 2001. The central tendency of projections for real GDP growth in 2000 was revised from 3½–3¾% in the February report to 4–4½%. Similarly, the central tendency for inflation (as measured by the Chain-Type Price Index for personal consumption expenditures) increased from 1¾–2% to 2–2¾%. The projection of the fourth-quarter unemployment rate (about 4%) did not change significantly. Projections for 2001 show a decrease in the growth rates of GDP and inflation and a very slight increase in the unemployment rate.

Proponents of the prevailing market view—that the current rate of real growth is unsustainable and ultimately inflationary—may welcome a slowdown. Several economic indicators had given cause for concern. The growth rate of personal consumption expenditures had exceeded that of disposable personal income. In other words, consumers' earnings increased, but their spending increased even faster. Even as the personal saving rate was declining, the wealth-to-income ratio was rising; this fueled fears that the so-called wealth effect could create disruptive imbalances. Recently, the stock market's growth has slowed, which should diminish the wealth effect. Furthermore, rising consumer interest rates have increased the cost of servicing debt, making it less attractive to finance current consumption through borrowing. In fact, recently released figures reveal that

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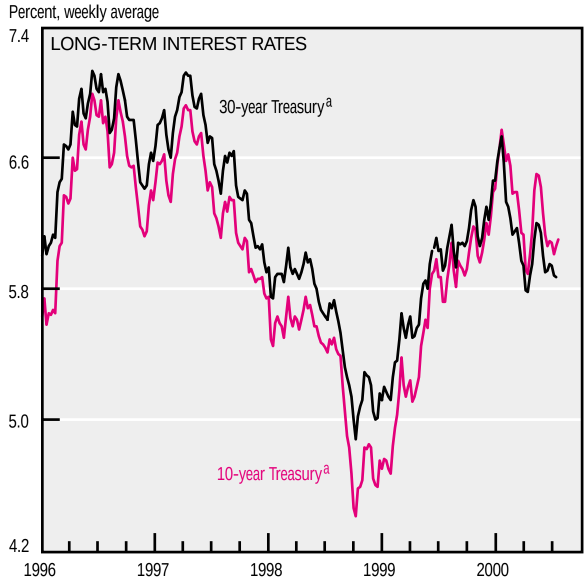

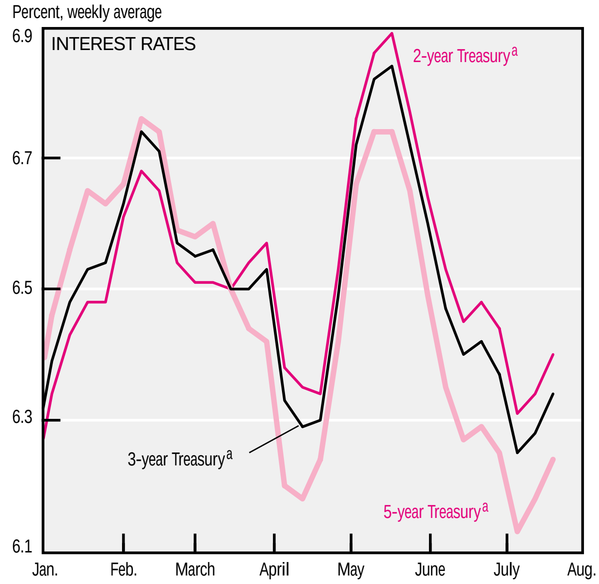

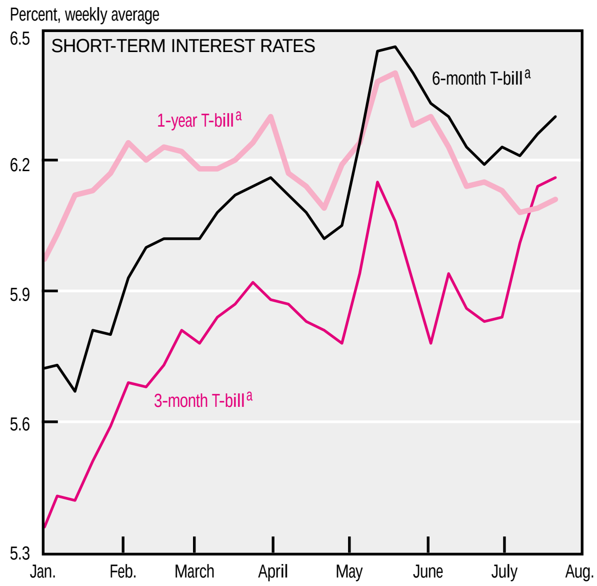

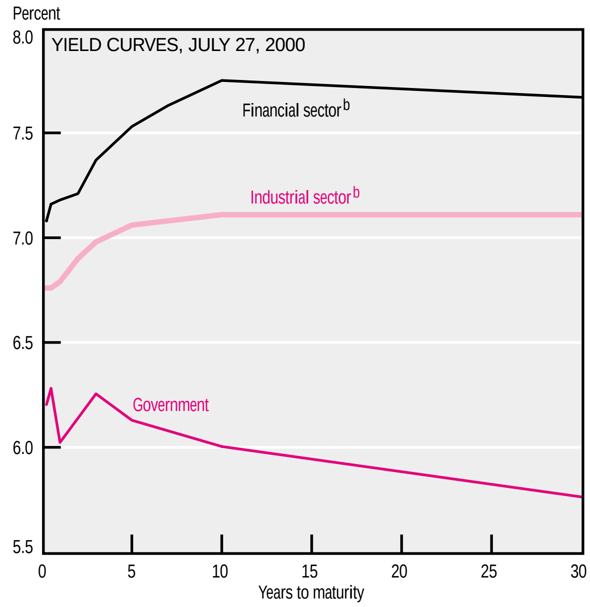

a. Constant maturity.

b. Option-adjusted yield curves are constructed by taking all bonds that fall into a given category (U.S. AAA industrial, for example), stripping away the portion of prices associated with embedded options such as puts, calls, and sinks, and then drawing a best-fit curve through the adjusted prices. Ratings are a weighted average of Moody's (60%) and Standard & Poors' (40%).

SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg Financial Information Services.

annualized personal consumption expenditure growth fell from 11.3% in the first quarter of 2000 to 5.4% in the second quarter.

For some time, the yield on the 10-year Treasury bond has been higher than that of the 30-year Treasury—an event termed an inversion of the yield curve. Supply factors, driven by federal budget surpluses and the U.S. Treasury Department's related debt-buyback program, have caused investors to bid up the price of long-term government debt, distorting the normal pattern of yields. Over the last few months, continued concern about declining supplies, strong economic activity, and rising short-term rates have led to a sharp yield-curve inversion, beginning at the 2-year Treasury note. At the short-term end of the maturity spectrum, the 1-year T-bill yield dropped below the 6-month T-bill at the beginning of May and dropped below the 3-month T-bill in early July.

In contrast, the yield curves on high-quality corporate debt have generally not inverted, although they are fairly flat; this suggests that the inversion in the yield curve for public debt may be due to special circumstances. When there are no atypical supply and demand factors, an inverted yield curve is often thought to signal an economic downturn, and a flat yield curve is deemed consistent with an outlook for moderate, noninflationary growth. The short-term portion of the corporate yield curve retains a strong upward slope.

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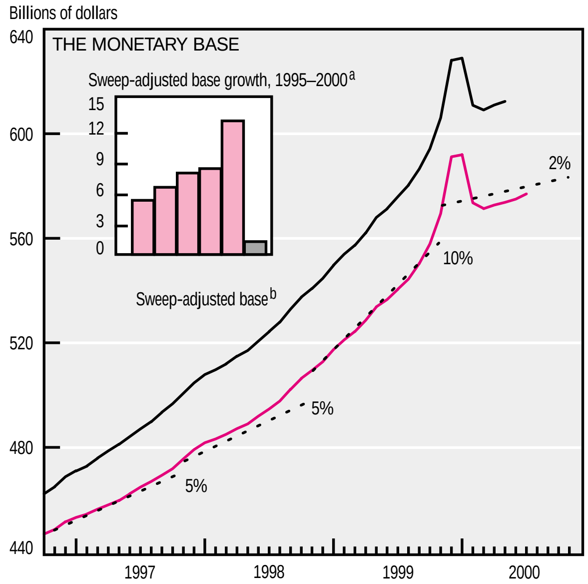

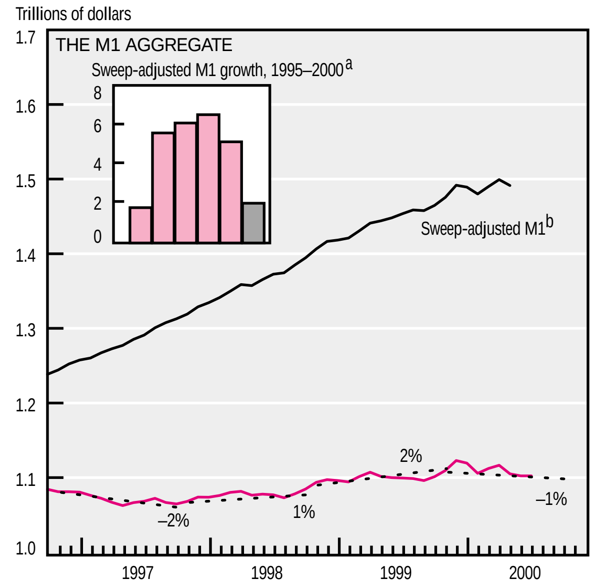

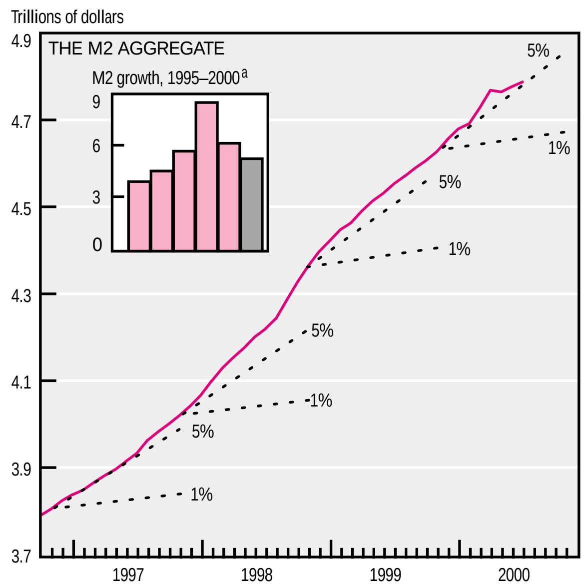

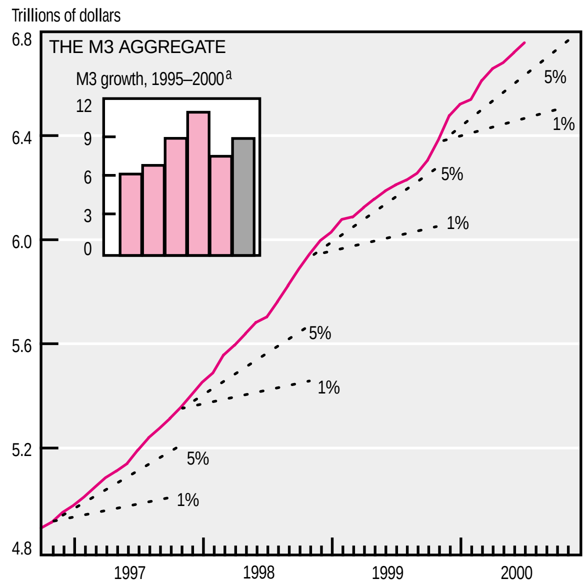

a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2000 growth rates for M2 and M3 are calculated on an estimated July over 1999:IVQ basis. The 2000 growth rates for sweep-adjusted base and sweep-adjusted M1 are calculated on a May over 1999:IVQ basis.

b. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts.

NOTE: Data are seasonally adjusted. Last plots for the monetary base, M1, M2, and M3 are estimated for July 2000. Last plots for the sweep-adjusted base and sweep-adjusted M1 are May 2000. Dotted lines for M2 and M3 are FOMC-determined provisional ranges (current ranges established February 2000). All other dotted lines represent growth rates and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

The Monetary Policy Report did not discuss FOMC-determined ranges for growth of the monetary and debt aggregates, a change which reflects the termination of Humphrey–Hawkins. “The legal requirement to establish and to announce such ranges had expired,” the Report notes, “and owing to uncertainties about the behavior of the velocities of debt and money, these ranges for many years have not provided useful benchmarks for the conduct of monetary policy.” The FOMC will no longer establish explicit ranges for money growth, but it “believes that the behavior of money and credit will continue to have value for gauging economic and financial conditions.”

Growth in the narrow monetary aggregates continues to be well below that of the last several years. Annualized year-to-date growth for the sweep-adjusted base and sweep-adjusted M1 were 1.0% and 1.9% through May, respectively, compared to 9.7% and 5.1% at the same time last year. Growth in the broad monetary aggregates is mixed. Annualized year-to-date growth of 5.2% for M2 in July was more than a full percentage point below the 6.5% recorded in July 1999. In contrast, annualized year-to-date growth of 8.9% for M3 in July is almost two percentage points above the 6.8% posted through July 1999.