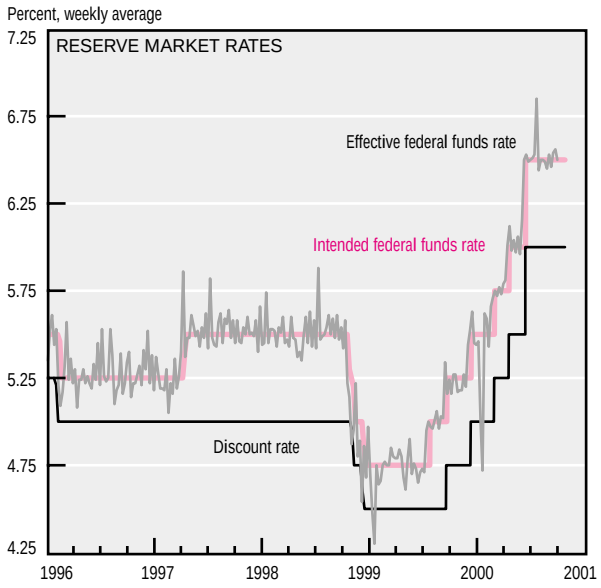
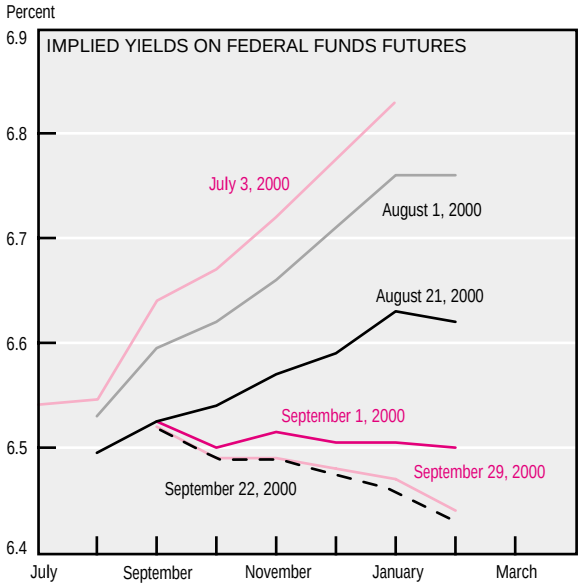
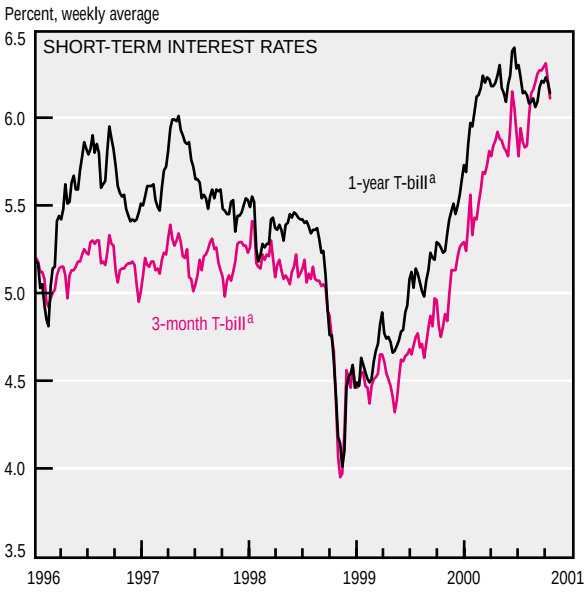
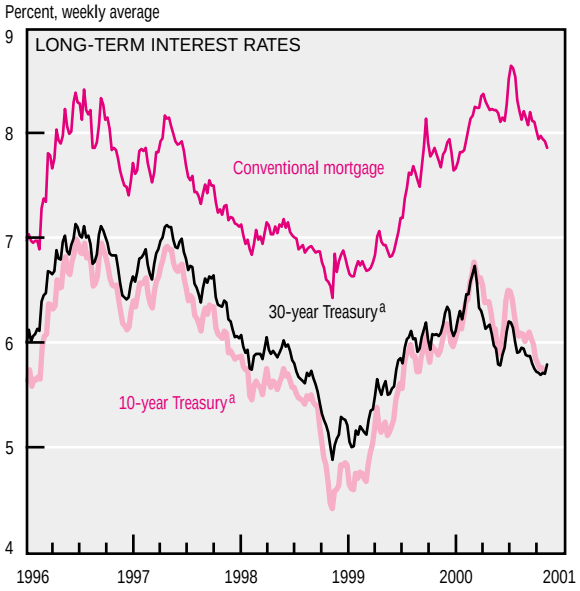
Monetary Policy









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

At its October 3 meeting, the Federal Open Market Committee (FOMC) left the intended federal funds rate unchanged at 6.5%. This is the third consecutive meeting that resulted in no change, following six increases totaling 175 basis points (bp). The FOMC cited moderating growth and rapid productivity advances as the reasons for its decision to leave the stance of monetary policy unchanged. However, it also stated that the balance of risk is weighted mainly by heightened inflationary pressure, specifically from the labor market, energy prices, and inflation expectations.

Since September, implied yields in the federal funds futures market have indicated that market participants saw an increase at the October meeting as less and less likely. In fact, the implied yield curve on fed funds futures has been inverted since September 1. At the margin, market participants expect the FOMC to lower the target rate in coming months. By September 29, the implied yield on the February contract had reached 6.41%, 9 bp lower than the October contract (6.5%) on the same date.

Interest rates appear to have stabilized somewhat after moving steadily upward since late 1999. Interest rate spreads on government securities have also tightened considerably, decreasing the inversion of the U.S. Treasury yield curve.

Short-term interest rate spreads narrowed sharply, briefly eliminating the inversion that first appeared in July at the short end of the Treasury yield curve. However, the reappearance of the typical, upward-sloping

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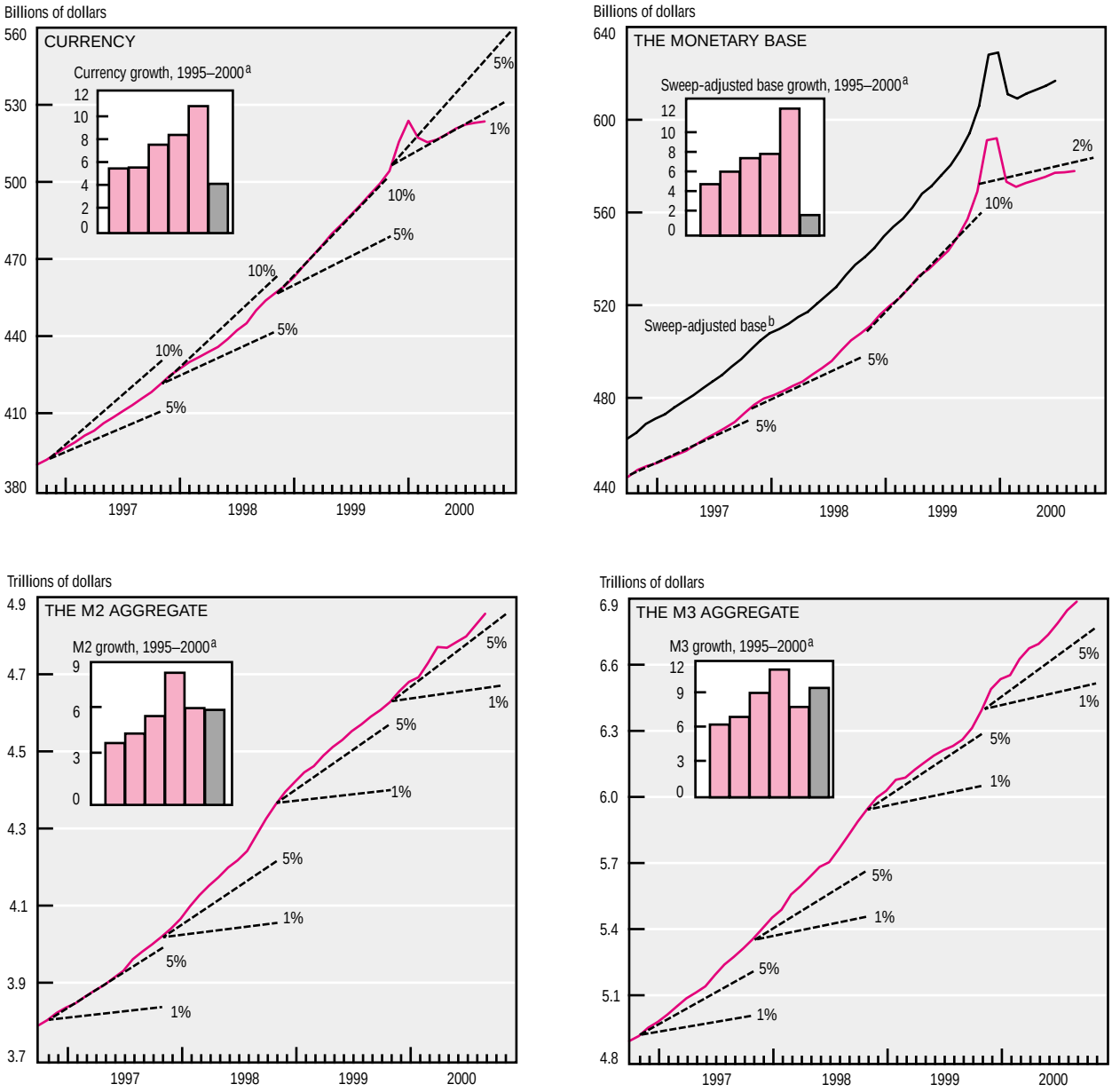

a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2000 growth rates for currency, the monetary base, M2, and M3 are calculated on an estimated September over 1999:IVQ basis. The 2000 growth rate for the sweep-adjusted base is calculated on a July over 1999:IVQ basis.

b. 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 currency, the monetary base, M2, and M3 are estimated for September 2000. Last plot for the sweep-adjusted base is July 2000. Dotted lines for M2 and M3 are FOMC-determined provisional ranges. All other dotted lines represent growth rates and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

yield curve lasted for only about a week. On September 28, the 3-month T-bill yield (6.2%) was again 12 bp above the 1-year T-bill yield (6.08%).

At nearly the same time that the yield on the 3-month T-bill slipped back below that on the 1-year T-bill, 10-year and 30-year Treasury bond yields also switched positions, reversing an inversion that had persisted since January. Unlike T-bills, the long-term rates' reversal appears to be enduring. As of September 29, the 10-year Treasury bond (5.83%) was yielding 6 bp below the 30-year Treasury bond (5.89%).

Growth in the narrow (more liquid) monetary aggregates has slowed significantly since last year. This is not a complete surprise, considering that rates on competitive securities went up. Another underlying factor is the run-down that followed the widely publicized increases in liquid assets prior to the century date change. Notably, growth in these narrower measures of money is well below that experienced during the last several years. Currency growth as of September is estimated at 4.1%, compared to 10.9% in 1999 and an average of 7.5% for the 1995–99 period. Similarly, year-to-date, sweep-adjusted base growth as of July (the most recent sweeps data available) was 1.8% (compared to 12.7% in 1999 and 7.9% for 1995–99).

By their very nature, the broad monetary aggregates are insulated

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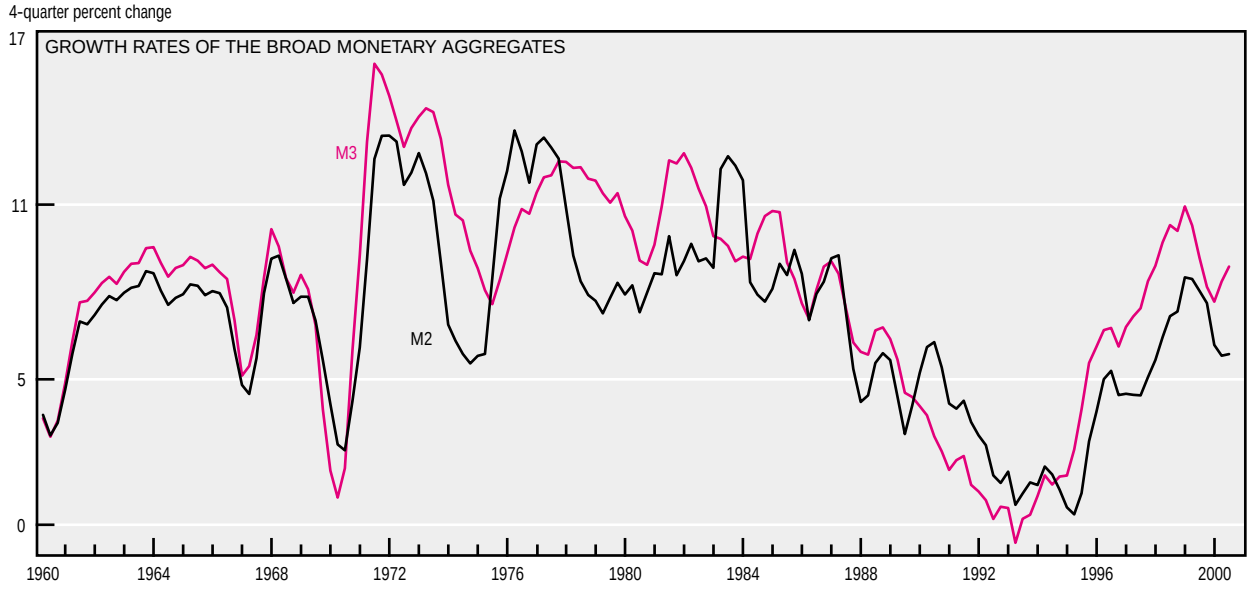

Components of the Broad Monetary Aggregates, 1999:IIIQ to August 2000

	Change, billions of dollars, 1999:IIIQ to August 2000	Percent contribution to change in total[a] Actual	Warranted
Institutional money funds	141.2	39.6	34.9
Large time deposits	151.2	42.4	38.5
Repurchase agreements	48.7	13.7	18.0
Overnight and term eurodollars	15.2	4.3	8.6

Components of the Broad Monetary Aggregates, 1984:IQ to January 1985

	Change. billions of dollars, 1984:IQ to January 1985	Percent contribution to change in total[a] Actual	Warranted
Institutional money funds	20.6	20.9	9.4
Large time deposits	74.8	75.9	59.0
Repurchase agreements	7.8	8.0	15.7
Overnight and term eurodollars	–4.9	–4.9	15.9

a. The actual contribution to the change in the total (where the total is M3 minus M2) is defined as the ratio of the change in the component to the change in the total. The warranted contribution to the change in the total is defined as the ratio of the component to the total.
SOURCE: Board of Governors of the Federal Reserve System.

from liquidity shifts, since they contain highly liquid assets like currency and checkable deposits as well as less liquid assets such as large-denomination time deposits and institutional money funds. Consequently, one would expect this diversity to have buffered M2 and M3 from Y2K-related expansion and contraction. Indeed, year-to-date M2 growth, estimated at 6.1% for September, was essentially unchanged from the 6.2% posted in 1999 and only about half a percentage point above its five-year average (5.7%). In strong contrast, however, year-to-date M3 growth as of September was a hefty 9.3% (compared to 7.7% in 1999 and 8.1% for 1995–99). The rapid growth of M3 was especially marked in the past quarter. While M3 was accelerating, M2 growth was actually slowing.

Given that M2 makes up such a large portion of M3 (about 70%), what is driving M3 growth? Judging from the historical shares of the non-M2 components that contribute to M3 growth, one would expect large time deposits to contribute almost 39% of the growth of M3 minus M2. Institutional money funds, on the other hand, would contribute nearly 35%. Yet institutional money funds have contributed close to 40% and large time deposits 42%. By this standard, both institutional money funds and large time deposits have overperformed since 1999:IIIQ, while overnight and term eurodollars and repurchase agreements have underperformed.

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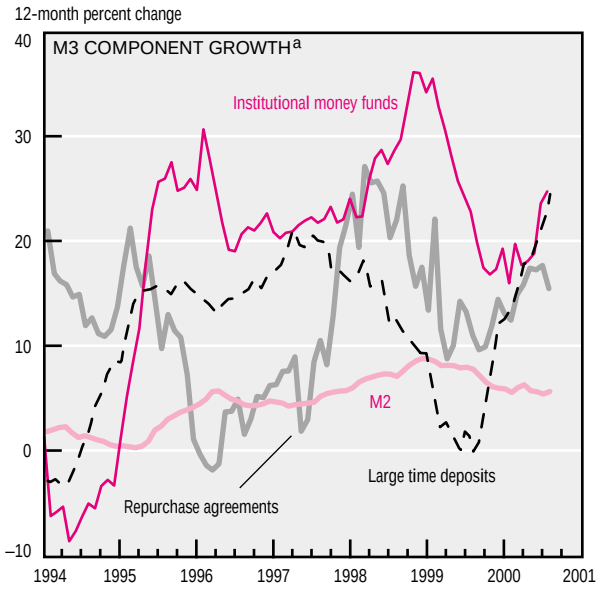

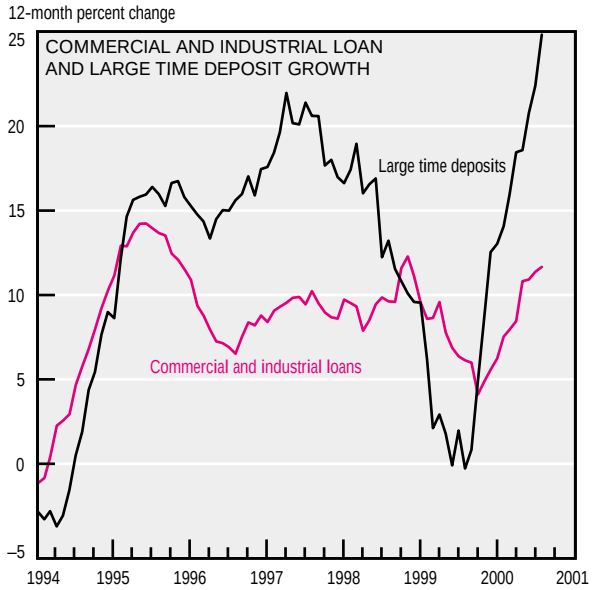

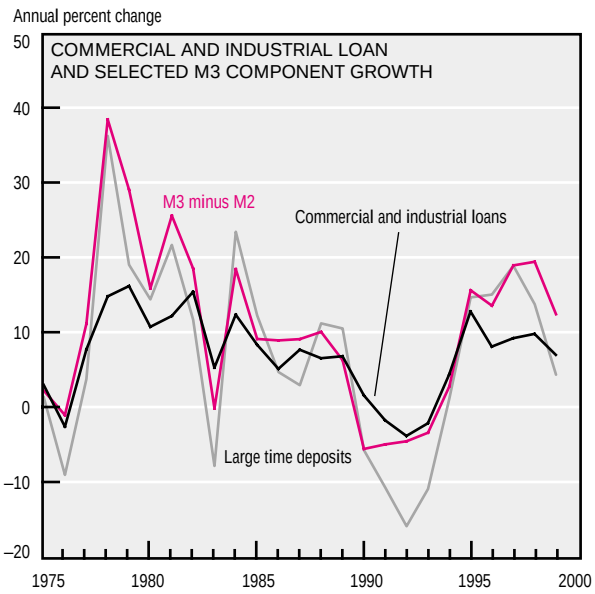

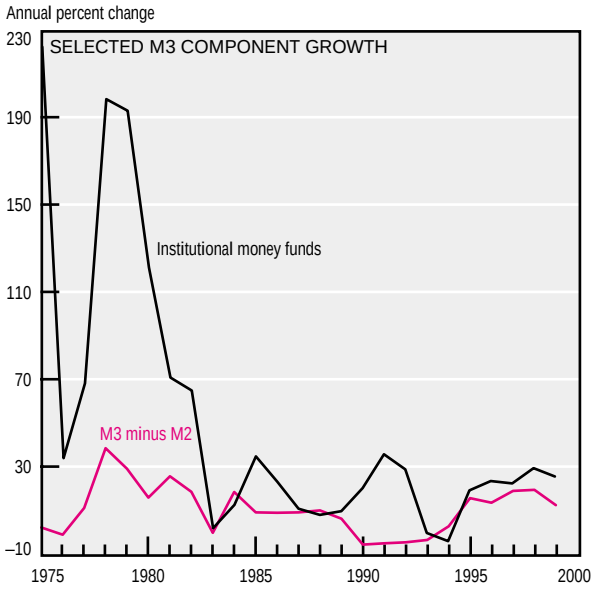

a. Overnight and term eurodollars, which have averaged less than 3% of M3 since January 1994, are not shown.
SOURCE: Board of Governors of the Federal Reserve System.

Looking back, there are remarkably few periods where M3 growth was increasing while M2 growth was decreasing, as it is currently. One such episode occurred between 1984:IQ and January 1985. During that period as well, institutional money funds and large time deposits overperformed, while overnight and term eurodollars and repurchase agreements underperformed.

Strong demand for commercial and industrial (C&I) loans, however, is frequently reflected in the rapid growth of large time deposits. Banks often raise funds to finance C&I loans by issuing large-denomination certificates of deposit, so annual growth of C&I loans is highly correlated with that of large time deposits (0.89). Predictably, C&I loan growth is also highly correlated with growth in the non-M2 components of M3 (0.90).

What can we conclude from this? Although the growth rates of the broad monetary aggregates typically move in harmony, there are episodes when M2 and M3 move in opposite directions. Often, this can be directly attributed to changes in large time deposits which, in turn, are affected by the demand for C&I loans. Investment has played a large part in the current expansion. As long as the recent increase in C&I loans represents productive investment, robust M3 growth is not a cause for concern; it reflects the underlying strength of the economy and not overly rapid money growth.