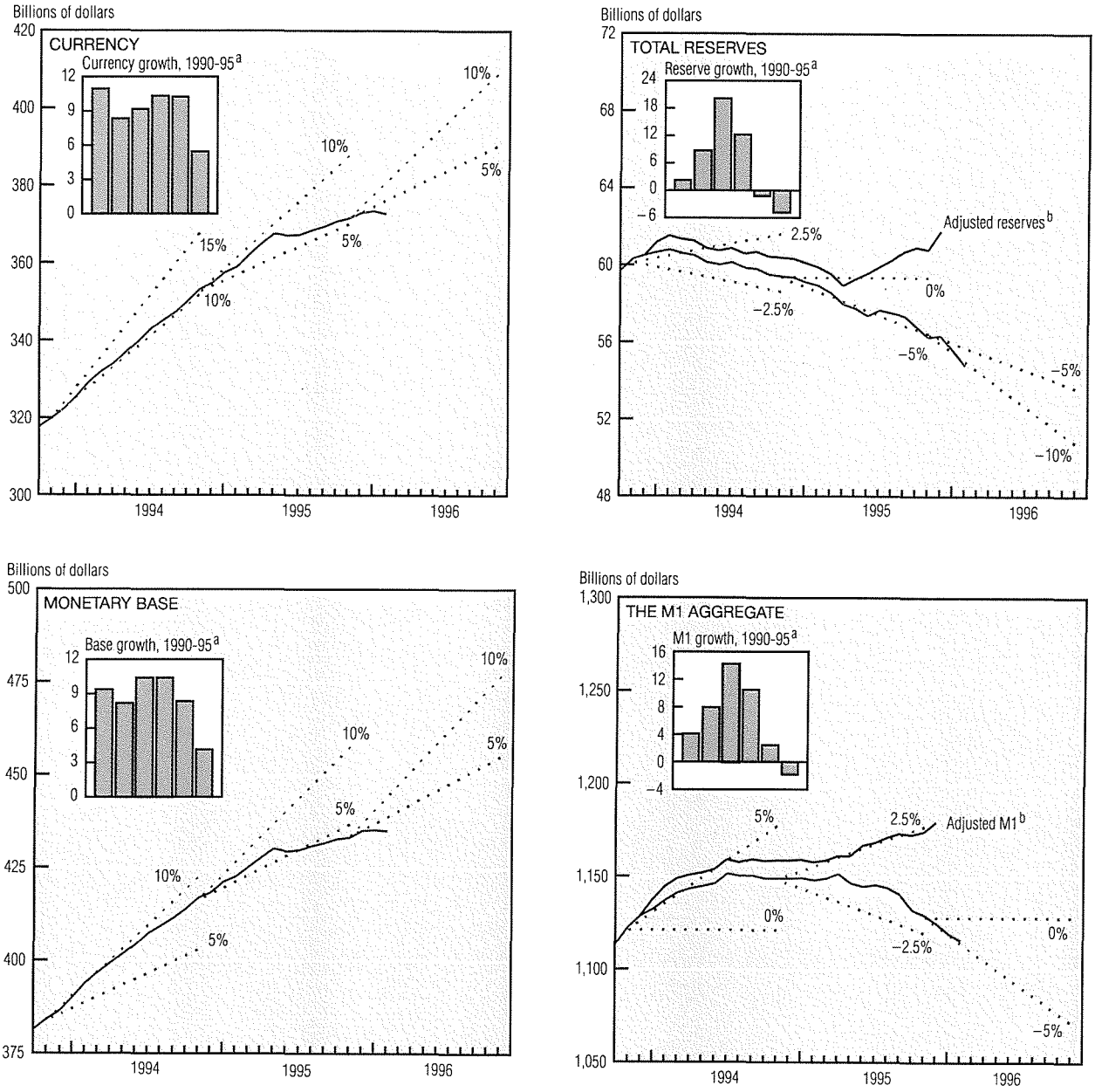
Monetary Policy



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.
b. Adjusted for sweep accounts.
NOTE: All data are seasonally adjusted. Last plot is estimated for February 1996. Dotted lines represent growth ranges and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

All of the narrow measures of money fell last month. Currency declined at a 2.5% rate, total reserves plunged 15.4%, the monetary base (which measures currency in the hands of the public plus reserves and currency held by banks) was down 1.0%, and M1 (which includes both currency and checkable deposits) dropped 3.9%. In January, currency increased 1.3% and the monetary base was up a meager 0.4%, while M1 and total reserves fell 3.9% and 15.7%, respectively.

One factor that is depressing both total reserves and M1 is the emergence of sweep accounts, which banks have initiated over the past few years in order to economize on their reserves. These arrangements "sweep" excess household checkable deposits, which are reservable, into money market deposit accounts, which are not. Analysts have estimated that absent these sweep accounts, total reserves would have expanded 1.3% over the past calendar year, instead of the sharp 4.9% decline that was actually posted. M1 would have grown 1.5% over the same period, instead of falling 1.8%.

Yet, even when the emergence of sweeps is taken into account, the narrow aggregates have all continued to show anemic growth over the past year. This has puzzled some observers, since the Federal Reserve has steadily decreased the funds rate target from 6.0% a year ago to 5.25% today. These apparent "easings" should have caused quicker growth in the narrow aggregates.

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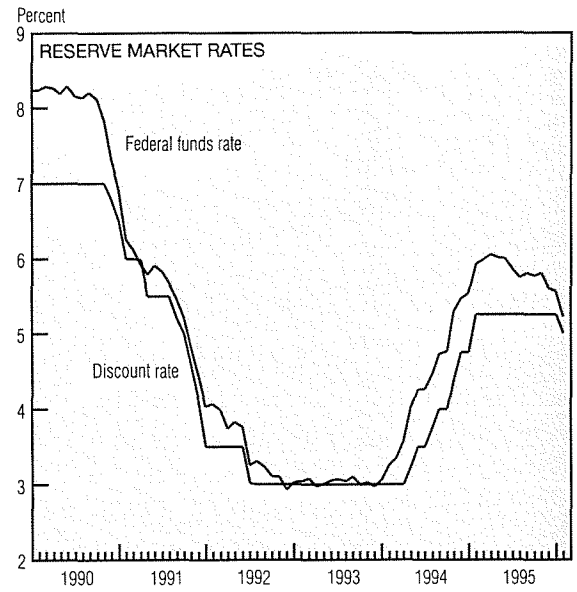
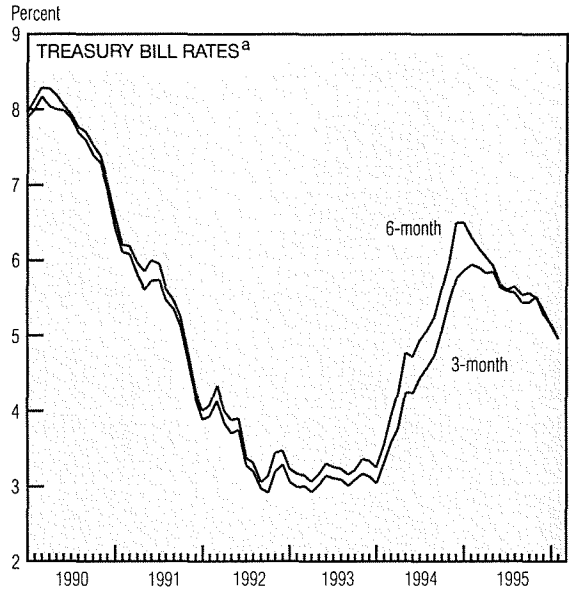
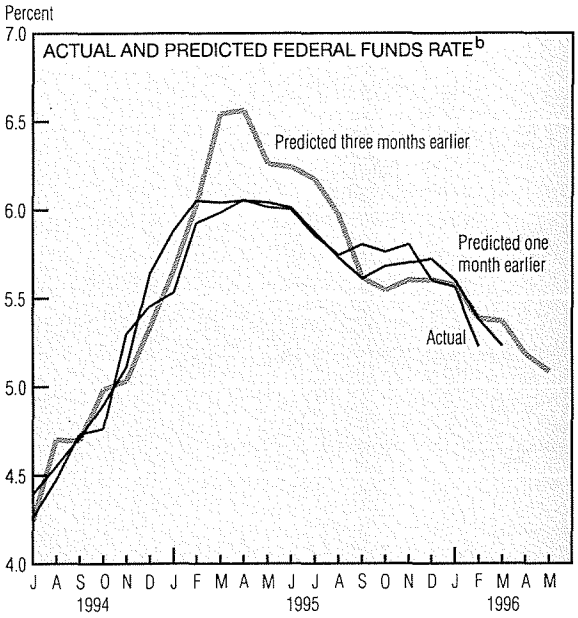
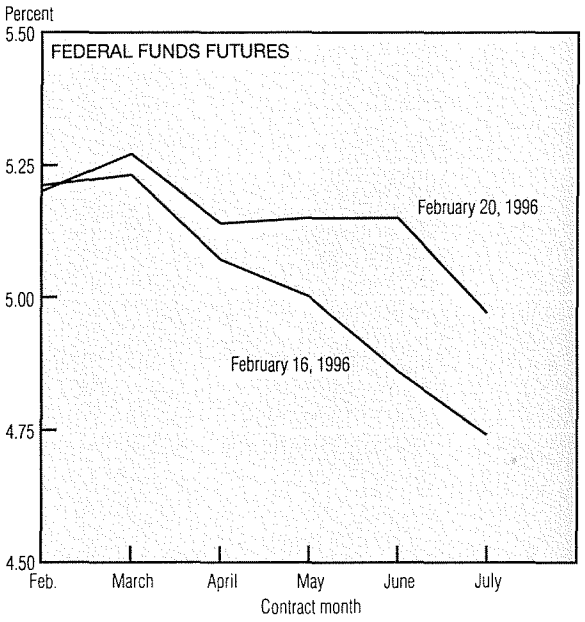
Monetary Policy (cont.)









a. Quoted from the secondary market on a yield basis.
b. Predicted rates are federal funds futures.
SOURCES: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

However, it may be a mistake to characterize the Fed's actions as an overt easing in monetary policy. Cuts in the federal funds rate for the most part followed reductions in other short-term interest rates. The 3-month T-bill yield has fallen from 5.9% a year ago to just under 5% today. Similarly, the 6-month T-bill yield has dropped from 6.3% to just under 5%.

There is evidence that the market is expecting further decline in the federal funds rate. The average fed funds futures rate over the past month suggests that market participants foresee that the funds rate will be trading at 5.1% by May. The anticipated decline, however, has become less pronounced following Chairman Greenspan's Humphrey–Hawkins testimony on February 20. Four days earlier, the market had been expecting the fed funds rate to be trading at 4.74% by July—50 basis points lower than its current target. After the Chairman appeared before Congress, that figure was revised to 4.97%.

Monetary policy has always been difficult to implement. For guidance, the preamble to the Federal Reserve Act states that one of the Fed's goals is "to furnish an elastic currency." An elastic currency is one that can be expanded or contracted quickly. This elasticity manifests itself across seasonal cycles. For instance, during the December holiday season and in the spring—when GDP growth is at its peak—money growth also reaches its highest point, limiting

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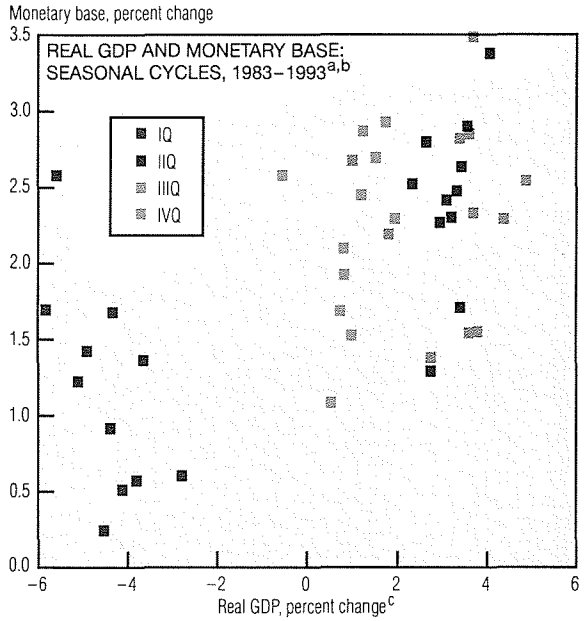
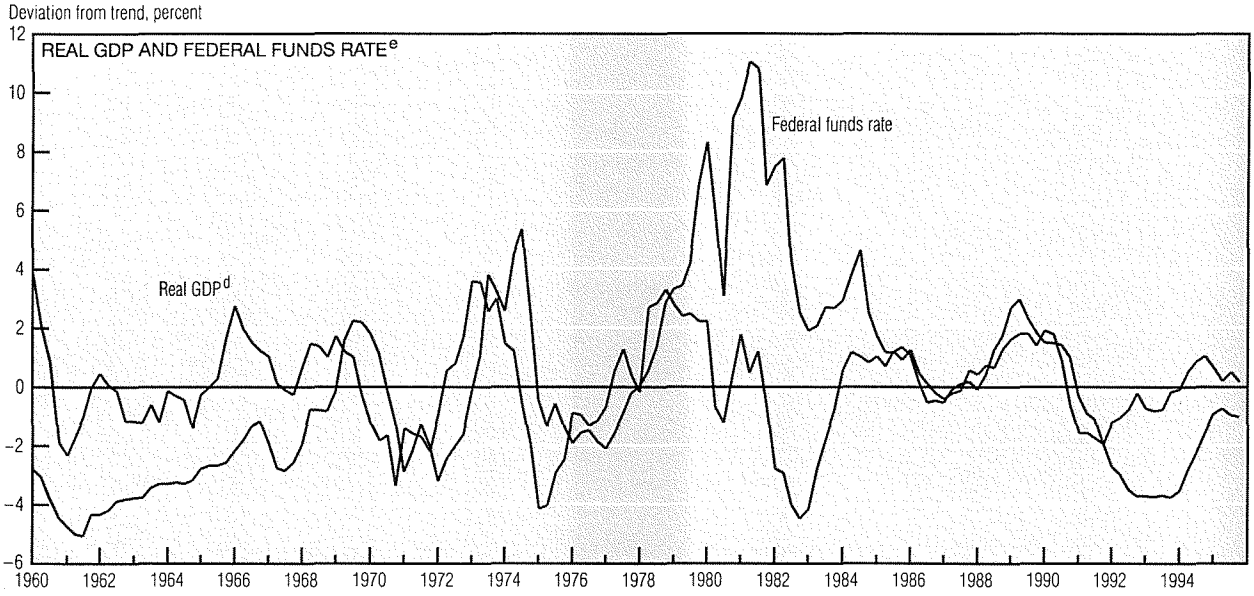


The Impact of Real GDP's Components
(Percent contribution to change in real GDP)

	Business cycles[d] (average)	Seasonal cycles[b,c] (median)
Nondurables and services	16	28
Durables	18	22
Business fixed investment	35	26
Change in inventories	39	14
Government spending	4	20
Net exports	−14	−6



a. 1983 to 1993 data are calculated as an annualized quarterly change.
b. Not seasonally adjusted.
c. Real GDP is defined as nominal GDP deflated by the CPI.
d. Seasonally adjusted.
e. The trend GDP is defined using a Hodrick–Prescott filter. The trend federal funds rate is defined as its average from 1960 to 1995.
SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and Robert Barro, *Macroeconomics*, fourth edition, New York: John Wiley & Sons Inc., 1993.

seasonal variation in interest rates.

Why is there general agreement that interest-rate variation should be held constant across the seasons, but not across the business cycle? This question is especially puzzling because evidence suggests that the seasonal and business cycles are quite similar. For example, the fraction of the change in GDP stemming from changes in durable-goods consumption, business fixed investment, and net exports is about the same for both cycles. The major difference can be found in the behavior of inventories, which should come as no surprise given that firms can predict seasonal cycles.

Even if one grants that the sources of shocks for the two cycles are different, recent economic research implies that it is still important for monetary policy to furnish an elastic currency across business cycles. Since households may be unwilling or unable to adjust their saving behavior quickly, this nominal sluggishness prevents cash from flowing to the banking sector during expansions. This suggests that money should be increased during expansions in order to supply needed reserves to the banking sector, which would in turn minimize business cycle variations in nominal interest rates. Although such a policy would lead to short-term variations in inflation, in the long term, inflation would be constrained by