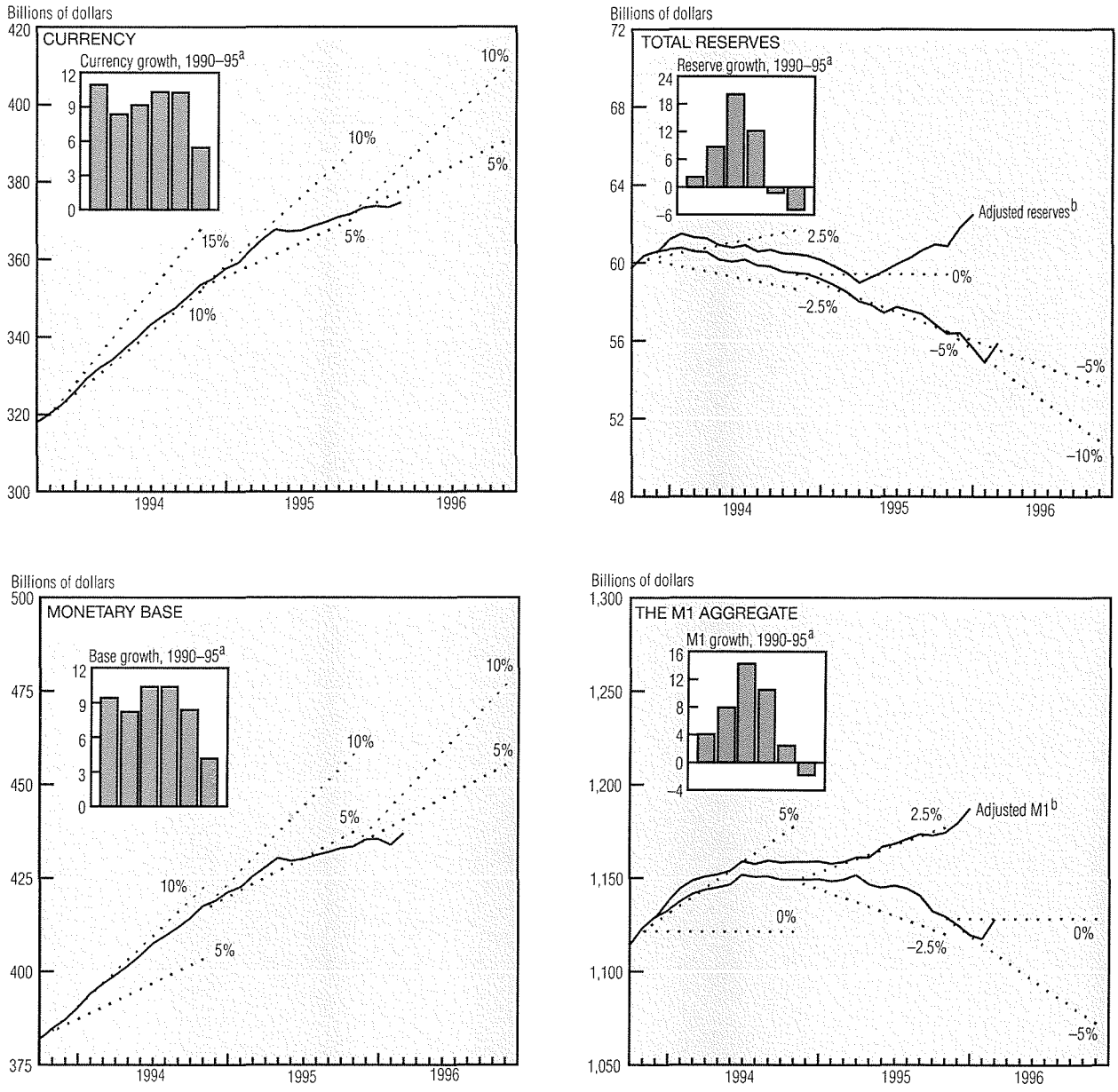
Monetary Policy



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 March 1996. Dotted lines represent growth ranges and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

In the past year, the Federal Open Market Committee has thrice voted to lower its key federal funds rate target: from 6% to 5.75% in July, to 5.5% in December, then to 5% in January. The funds rate—the interest rate paid on overnight loans of reserves between banks—represents the key information guiding open-market operations for control of bank reserves. Because reserves are the raw material for the creation of monetary assets by the banking system, their control is the channel through which central bank operations affect the supply of money in the economy.

In essence, the federal funds rate is the price of obtaining reserves. Thus, when demand for reserves exceeds supply, the rate tends to rise, and vice versa. All else being equal, then, maintaining a lower funds-rate target implies a greater supply of reserves by the monetary authority and, presumably, a more rapid expansion of money.

Of course, all else is not always equal, and blanket interpretations of rising and falling funds-rate targets are ill-advised. Still, the past year's coincidence of falling rates and slow growth or outright declines in the narrow money measures—total reserves, the monetary base, and M1—can't help but be puzzling to most observers.

The resolution of the puzzle seems to be found in sweep

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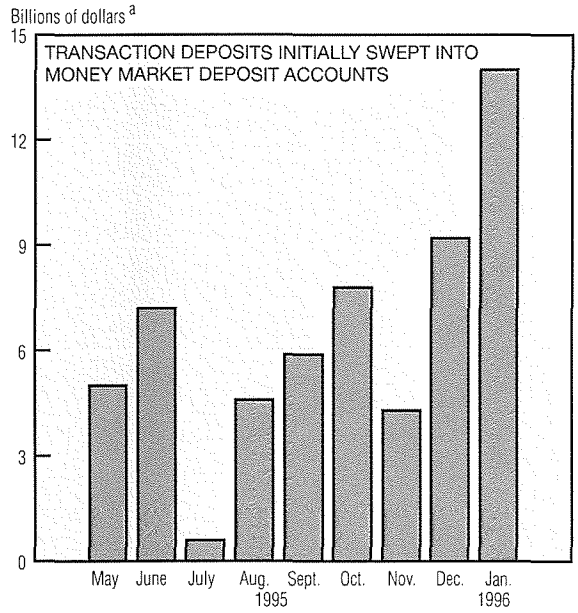
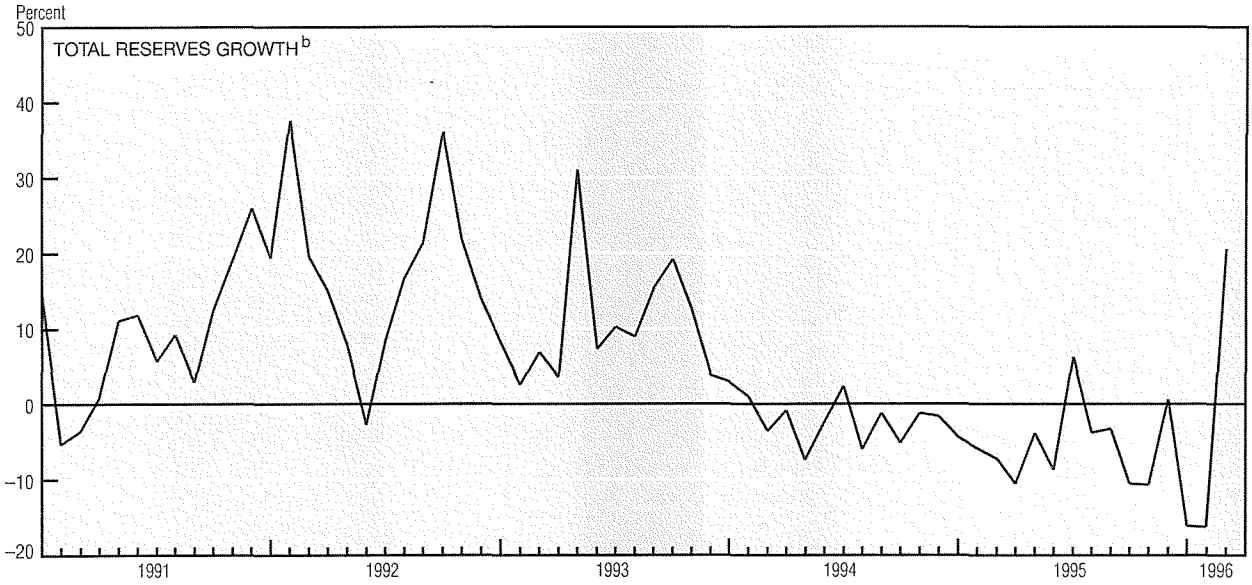
Monetary Policy (cont.)

Transaction Deposits Initially Swept into Money Market Deposit Accounts
(Billions of dollars[a])

	Quarterly averages	Cumulative total
1994:IQ	7.5	7.5
1994:IIQ	0.0	7.5
1994:IIIQ	1.5	9.0
1994:IVQ	0.9	9.9
1995:IQ	0.0	9.9
1995:IIQ	12.2	22.1
1995:IIIQ	11.1	33.2
1995:IVQ	21.3	54.5
January 1996	14.0	68.5





a. Not seasonally adjusted.
b. Last plot is estimated for March 1996.
SOURCE: Board of Governors of the Federal Reserve System.

accounts. Created to help banks economize on the reserves that are required to support demand deposits, these accounts involve the very short-term "sweeping" of checkable deposits into money market deposit accounts. These activities are essentially invisible to the households that own checkable deposits, and so have little impact on true transaction balances. However, sweep activities can, and apparently do, significantly depress reserves and other narrow money measures.

Sweep accounts began appearing on the monetary radar screen in 1994 and have grown in importance since then. From the first quarter of 1994 through the fourth quarter of 1995, the cumulative total of transaction deposits initially swept into money market deposit accounts has risen more than sevenfold. At the same time, the disparity between narrow-money growth rates before and after adjusting for sweeps has increased. Throughout most of 1995, unadjusted total reserves and unadjusted M1 actually declined, while adjusted measures grew.

These circumstances suggest potentially large changes in the way we "read" monetary developments. Attendant to any such changes is the question of how these developments alter the central bank's ability to exercise monetary control.

Fortunately, there is thus far little evidence that the sweep account

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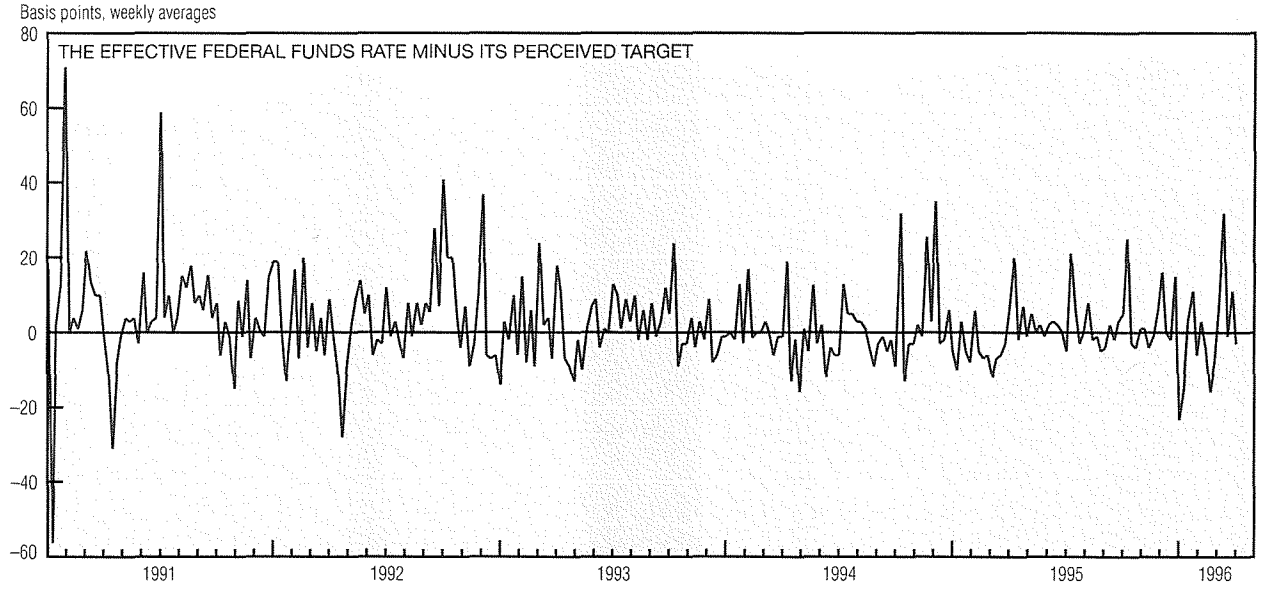
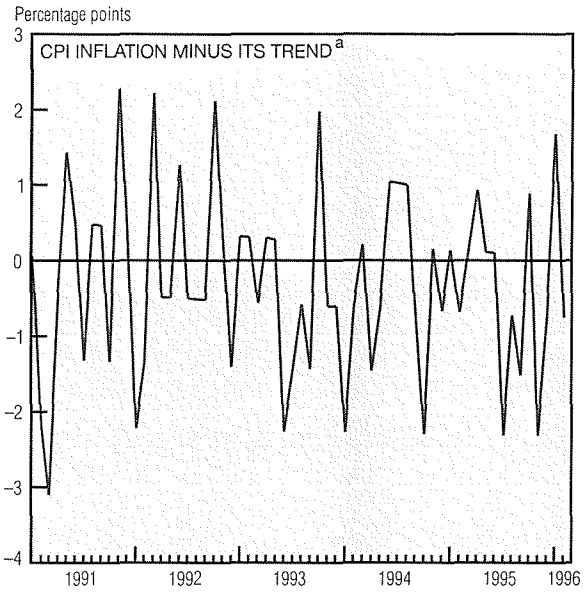
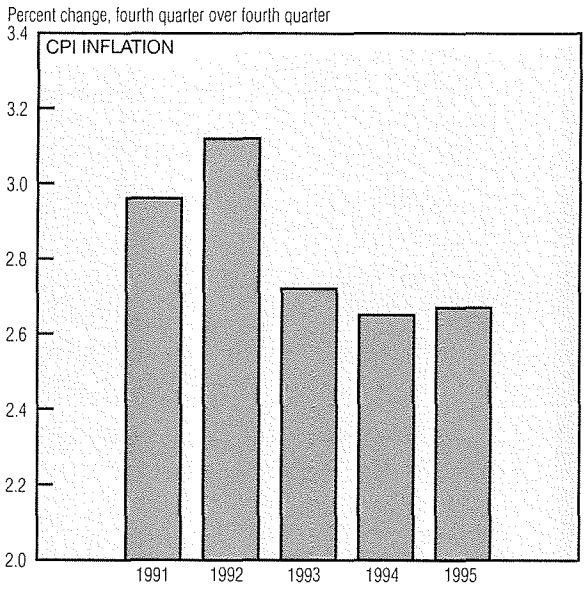
Monetary Policy (cont.)







a. Trend CPI inflation is defined using median CPI breakpoints.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and Board of Governors of the Federal Reserve System.

phenomenon has substantially affected the key aspects of monetary operations. Although the level of total reserves has certainly been altered by sweep activities, the volatility of reserves appears unchanged. Similarly, the variability of the federal funds rate about the announced or perceived targets has not been greater in the two years since sweeps were introduced than it was in the two years before their creation. In fact, the standard deviation of the rate from implied targets in the 1991–93 period was actually greater than deviations from the target in the period since the first quarter of 1994.

The funds rate is, of course, not an end in itself. The same can be said of monetary growth. They are merely instruments for the conduct of monetary policy, the ultimate aim of which involves broader macroeconomic performance. Price-level or inflation outcomes are particularly important. There can be little solace in the fact that financial market developments like sweep accounts do not much affect the central bank's ability to control, say, the federal funds rate, if at the same time inflation rises or becomes significantly more volatile.

Fortunately, there is again no evidence of unusual monetary policy behavior in the period since the beginning of 1994. Inflation has been roughly constant for three years running, as has been the standard deviation about trend. In this important respect, the introduction of sweep accounts has been a nonevent.