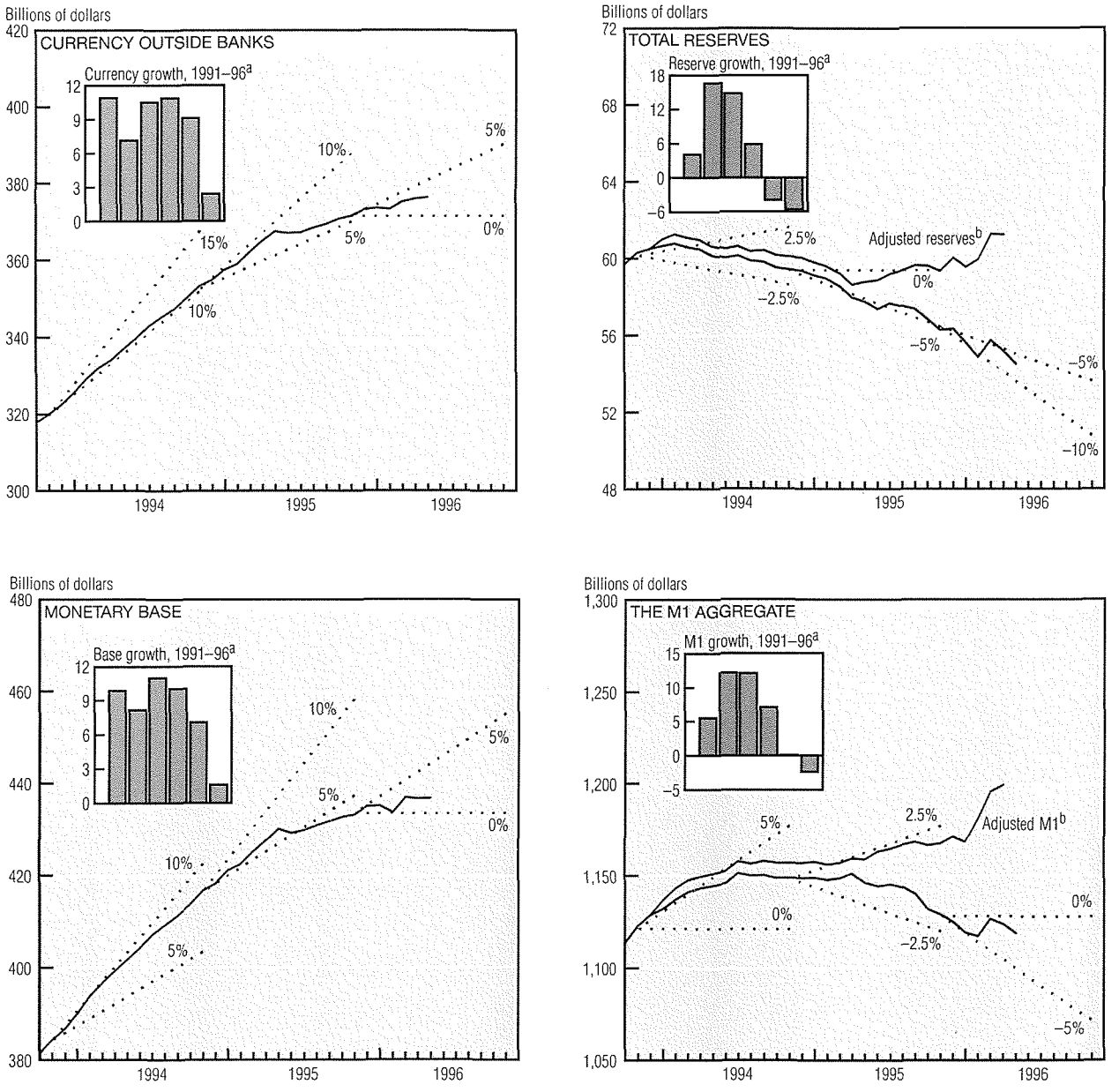
# Monetary Policy




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

Except for the monetary base and currency, all of the narrow measures of money fell last month. Currency grew at a 1.7% annualized rate; total reserves continued to plunge, down 15.1% after April's 11.7% drop; and M1, which includes both currency and checkable deposits, fell 5.1%. The monetary base, which measures currency in the hands of the public plus reserves and currency held by banks, increased a paltry 0.6%.

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 to economize on their reserves. These arrangements "sweep" excess household checkable deposits, which are reservable, into money market deposit accounts, which are not. It is estimated that absent these sweep accounts, total reserves would have expanded 4.5% over the past calendar year instead of plummeting 5.7%. Similarly, M1 would have grown approximately 3.4% instead of falling 2.4%.

Over the past year, the federal funds rate has been cut repeatedly from 6% last June to 5.25% today. However, these Federal Reserve policy actions—and the ones that preceded them—closely followed changes in other market interest rates. For example, the one-year T-bill yield peaked in January 1995 and immediately started its descent. The fed funds rate peaked two months later and did not start declining until July 1995.

This suggests that it may be a mistake to characterize the Fed's

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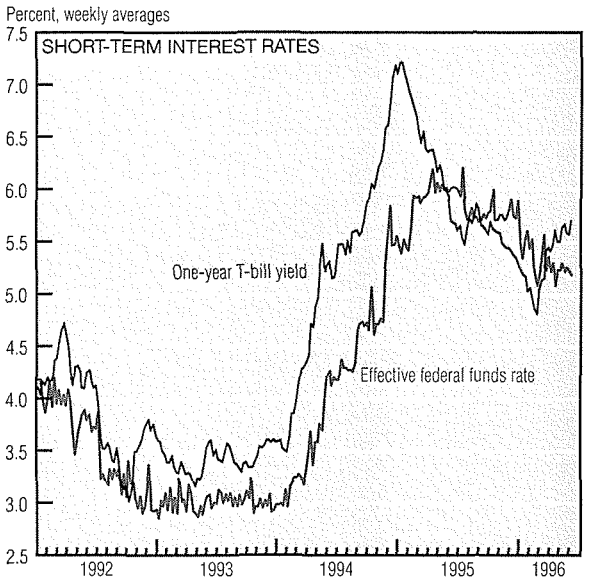
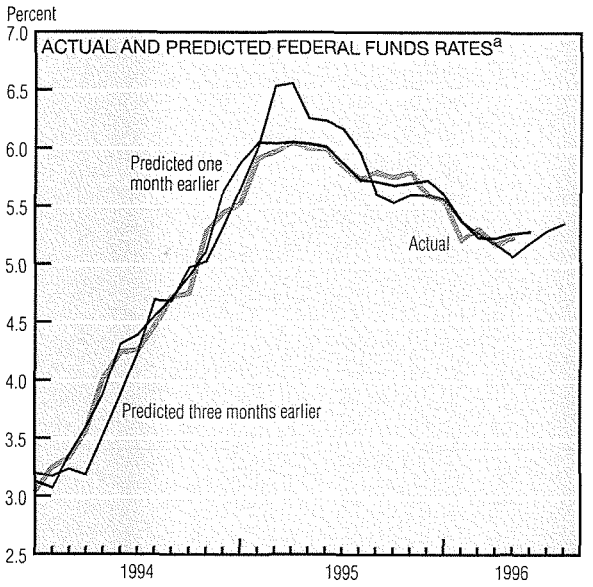
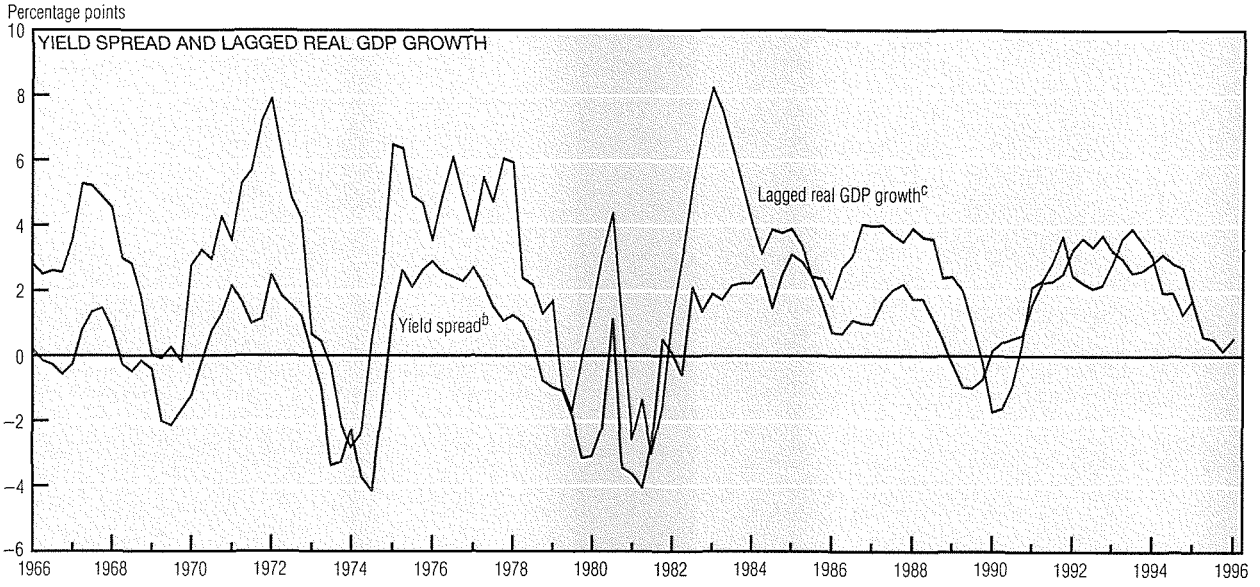
# Monetary Policy (cont.)




a. Predicted rates are federal funds futures.
b. The yield spread is defined as the 10-year Treasury yield minus the effective federal funds rate.
c. Real GDP growth is lagged one year and is a year-over-year change.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

recent actions as reflecting an overt easing in monetary policy. The latest increases in other short-term interest rates (the one-year T-bill yield recently advanced to 5.7% from 5.5% in April) imply that the fed funds rate will have to start rising shortly to prevent an indirect easing of monetary policy.

The market does appear to expect a moderate upturn in the funds rate before the summer is out. The average fed funds futures rate over the last month implies that investors are expecting the funds rate to be trading at 5.4% by August.

Surprisingly, a strong signal of future GDP growth is given by the difference between the yield on a 10-year Treasury bond and the fed funds rate. Movements in the yield spread can significantly predict output growth four quarters into the future. There are two possible reasons for this phenomenon. The first is that the spread primarily arises because of policy actions undertaken by the Fed. That is, increases in the fed funds rate today cause GDP to decrease nearly one year later. The second theory posits that this correlation does not reflect the ability of deliberate policy actions to affect real growth, but occurs because long-term bond yields are positively associated with future GDP growth. That is, if people expect future output growth to be high, savings will decline today and thus put upward pressure on the real interest rate.

A simple way to distinguish between these alternative explanations is to examine whether the strong correlation is coming from a positive

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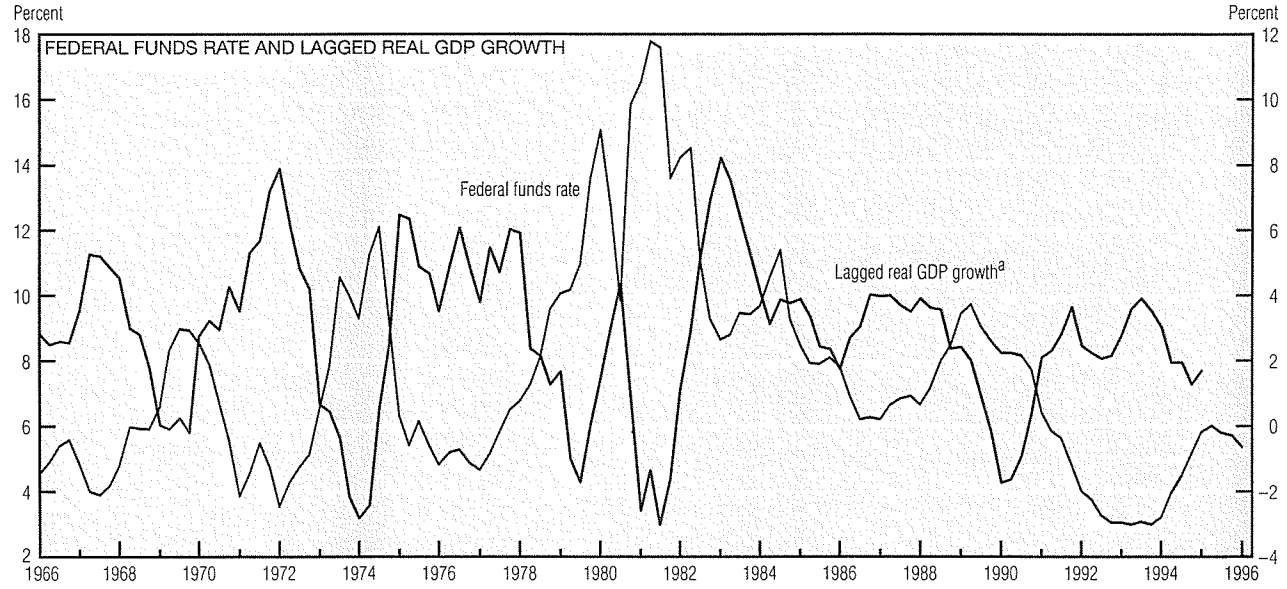


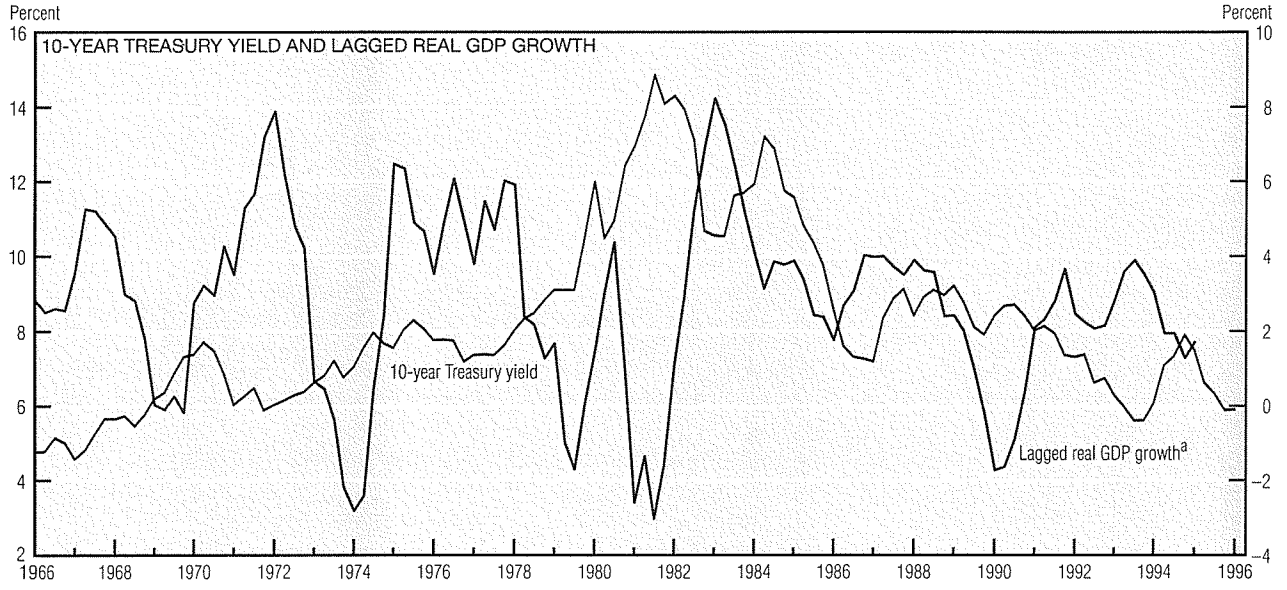


a. Real GDP growth is lagged one year and is a year-over-year change.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

association between GDP growth and long-term yields, or from a negative association between the fed funds rate and future GDP growth. The charts presented here indicate that there is indeed a strong negative correlation between the funds rate and future GDP growth, and dispute the story that long-term yields rise when future output is expected to increase.

Why, then, is the yield spread a better predictor of future output growth than the fed funds rate alone? The answer may be found in the fact that decreases in the real funds rate—the nominal rate adjusted for inflation—should be a better predictor of future increases in output than are decreases in the nominal funds rate. If the yield on long-term bonds is a good proxy for changes in near-term inflation expectations, then increases in the yield spread could be a better gauge of decreases in the real funds rate than are decreases in the nominal funds rate.

Two conditions must hold for this to be the case: First, changes in long bond yields must primarily reflect changes in expected inflation. This seems reasonable, since real interest rates remain fairly constant over long periods. Second, recent inflation developments must weigh heavily in the formation of long-term inflation expectations. Many economists believe this to be true. Essentially, then, revisions in inflation expectations dominate changes in the 10-year Treasury yield, and increases in the yield spread will reflect decreases in the real federal funds rate.