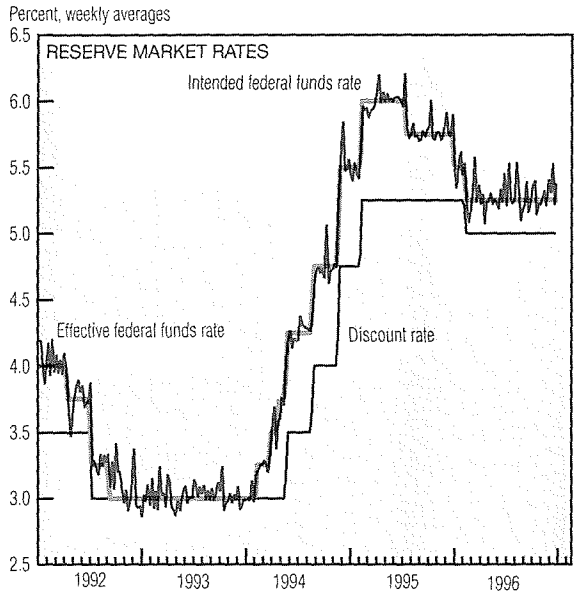
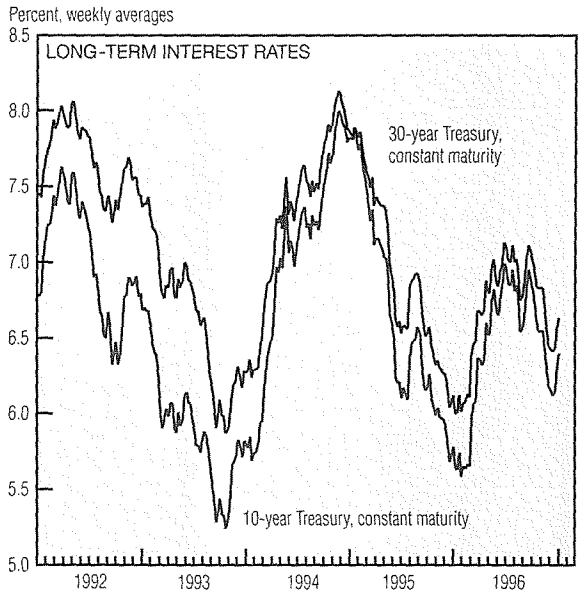
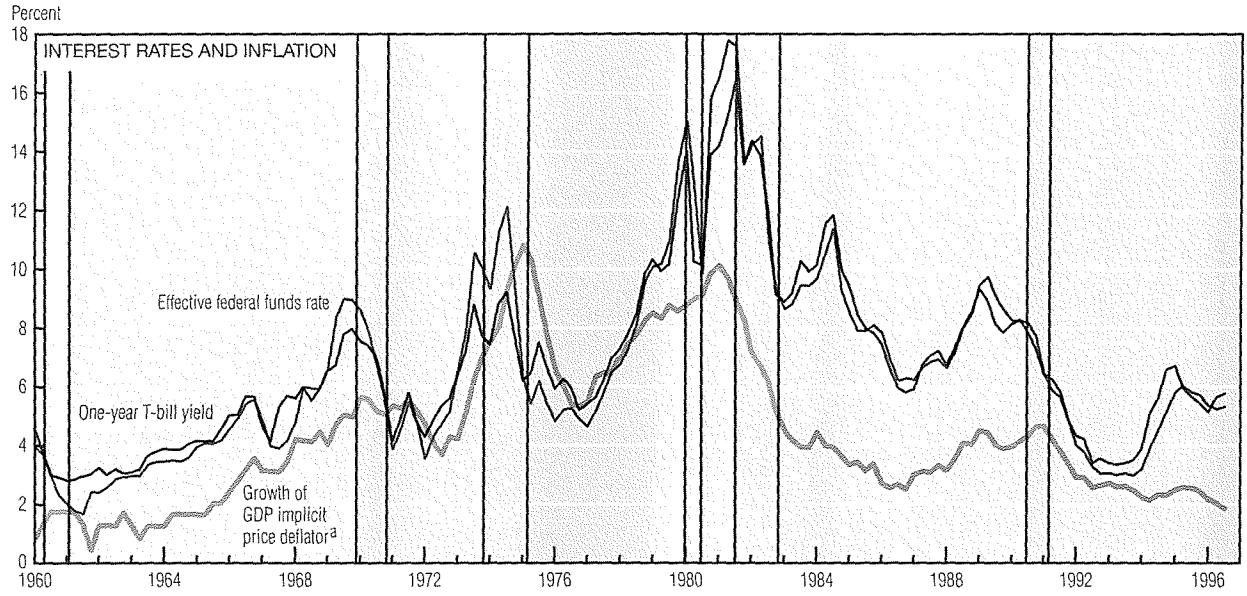
Monetary Policy







a. Four-quarter growth rate.
NOTE: Shaded areas indicate recessions.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

At its December 17 meeting, the Federal Open Market Committee again left the intended federal funds rate unchanged at 5.25%. It is now approaching one year since the Committee last altered its federal funds rate objective, a 25-basis-point reduction that occurred following its January 31, 1996 meeting.

While the federal funds rate has remained constant, long-term interest rates have varied somewhat over the past year. The 30-year Treasury constant-maturity rate reached a 1996 high of 7.28% during the week of June 6, before falling to its current level of around 6.5%.

Although short-term interest rates have risen relative to their levels in early 1993, they remain low relative to their averages over the last two decades. In fact, one must go back to the mid-1960s to find a period of sustained low short-term rates matching the average level posted over the last four years. Not coincidentally, one must also go back to the 1960s to find a sustained period of low inflation comparable to the average inflation rate over the past 10 years.

It is a widely accepted view in economics that over long periods, growth in the supply of money determines the inflation rate and has

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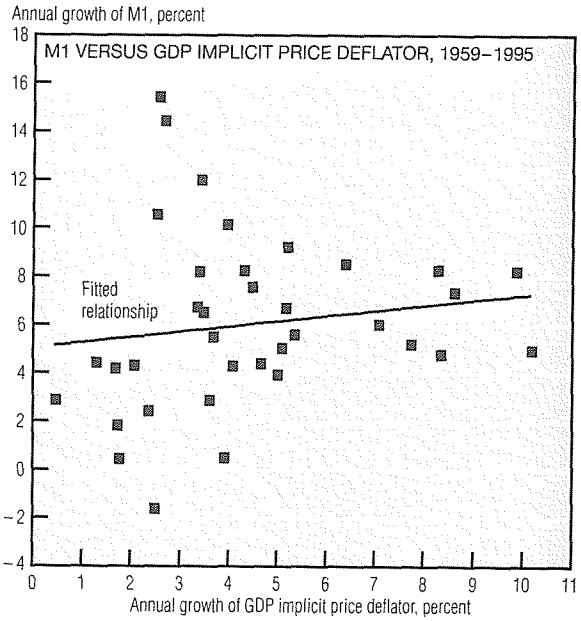
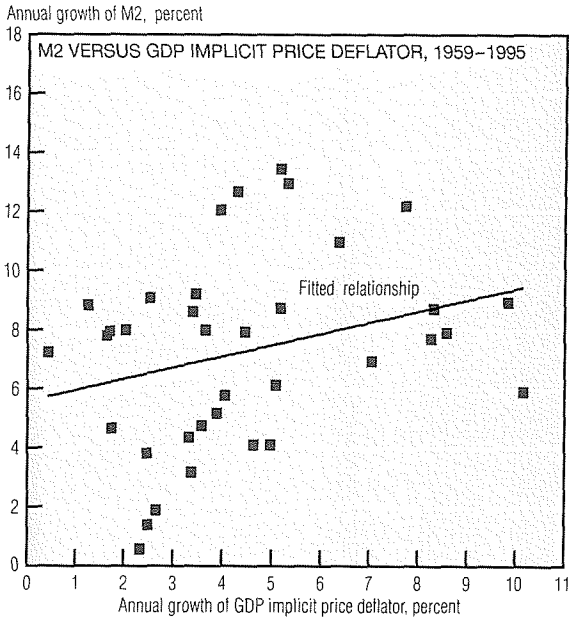
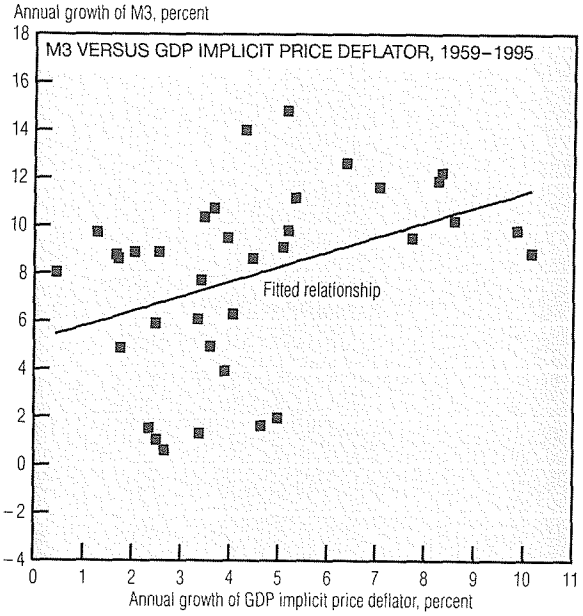
Monetary Policy (cont.)

Average Annual Growth Rates of Money, Output, and Prices
(Percent)

	1959–1995	1959–1969	1969–1982	1982–1995
M1	6.0	3.8	6.7	6.9
M2	7.2	7.0	9.5	5.1
M3	7.9	7.5	11.2	4.9
Nominal GDP	7.7	6.9	9.6	6.4
Real GDP	3.1	4.3	2.4	3.0
GDP deflator	4.4	2.5	7.0	3.3







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

little effect on the real growth rate of the economy. However, there is some evidence linking lower inflation with higher real growth. From 1959 to 1995, M1, M2, and M3 grew between 6% and 8% per year, while real GDP increased at a 3.1% annual rate. This growth in the monetary aggregates led to a 4.4% increase in inflation as measured by the GDP implicit price deflator.

Over this period, inflation rates were highest from 1969 to 1982. Average annual inflation stood at 2.5% from 1959 to 1969, at 7.0% from 1969 to 1982, and at 3.3% from 1982 to 1995. A natural question, then, is whether the 1969–82 period was also characterized by faster-than-average growth in the monetary aggregates.

The answer is a qualified yes. Both M2 and M3 displayed much faster growth during these years than in the earlier and later periods. While M1 increased substantially from 1969 to 1982 compared to the earlier period, it again rose slightly between 1982 and 1995. It is interesting to note that during these three periods, average real GDP growth was inversely related to the average rate of inflation.

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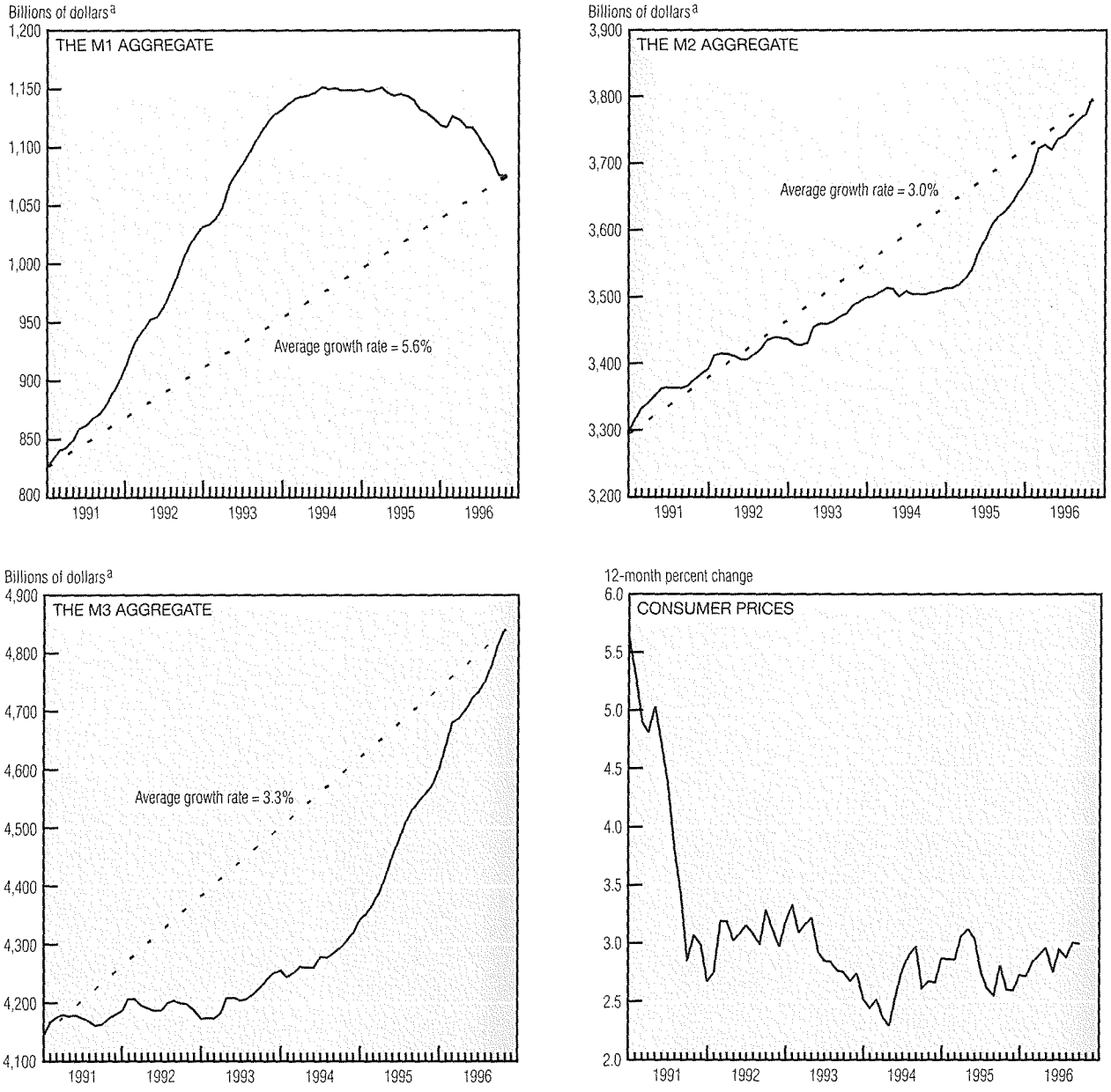
Monetary Policy (cont.)



a. Seasonally adjusted.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System.

Although growth in the money supply and inflation have a fairly close relationship over the long term, this relationship is much less reliable over shorter periods. Plots of the monetary aggregates' annual growth rates against annual inflation rates from 1959 to 1995 illustrate that the connection between money growth and inflation is not very precise over short periods, although a positive relationship does exist.

Because of this imprecision, recent data (up to one year) on the growth of the monetary aggregates provide little insight on the inflation rate. In contrast, looking back over five years may shed some light on recent and expected future levels of inflation.

Since the beginning of 1991, M1 has grown at an average annual rate of 5.6%, while M2 and M3 have climbed 3.0% and 3.3%, respectively. The relatively low average annual inflation rate (3.1%) posted during this period is not surprising in light of these subdued money growth rates. To the extent that the monetary aggregates continue to expand at similar rates, we can expect long-term inflation to continue its downward trend.