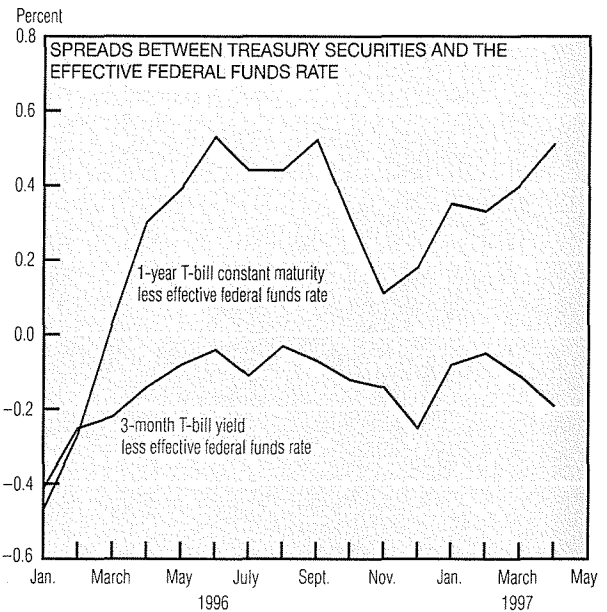
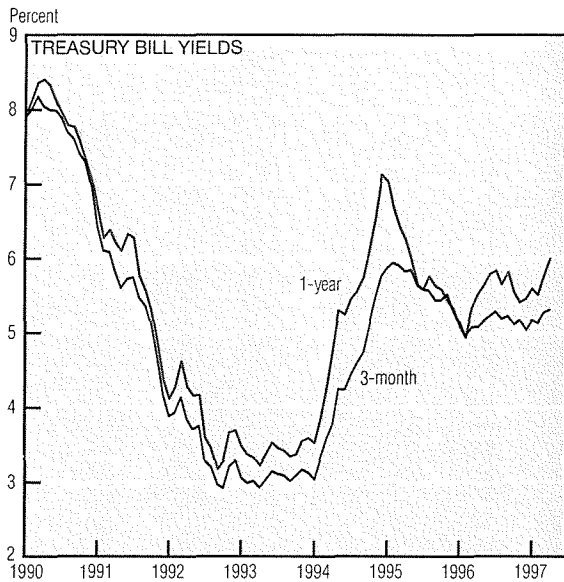
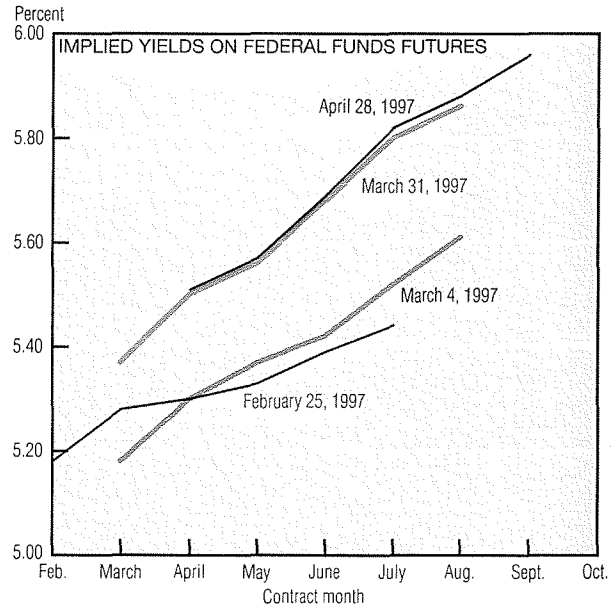
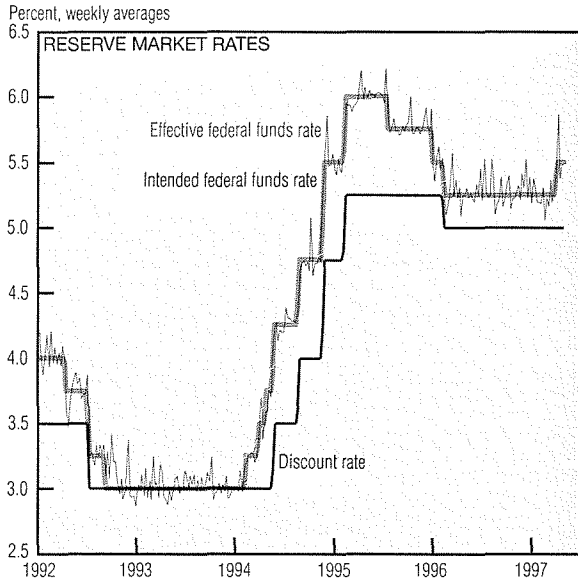


# Monetary Policy



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

Since the Federal Open Market Committee (FOMC) announced an expected ¼-percentage-point increase in the federal funds rate at its March 25 meeting, short-term interest rates have changed very little. As of April 29, the three-month Treasury constant-maturity yield had fallen five basis points (b.p.) from its March 28 level, while the yield on one-year maturities had declined two b.p. Long-term interest rates were also relatively constant over this period.

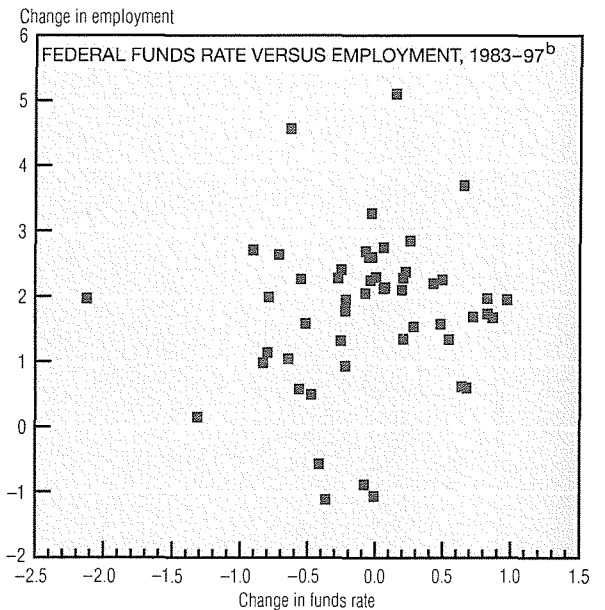
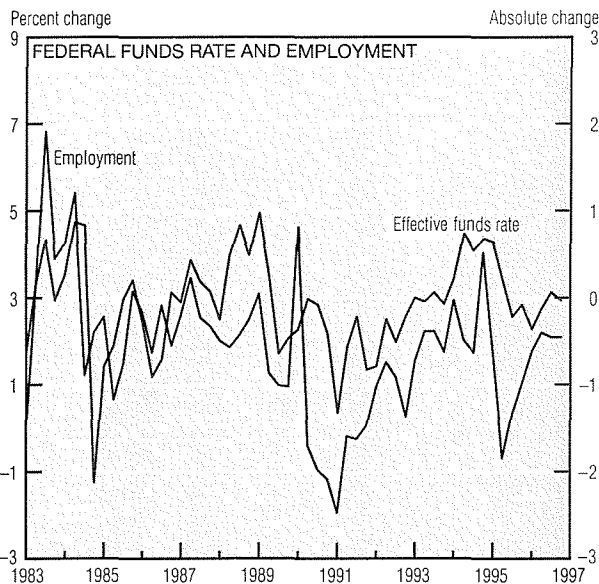
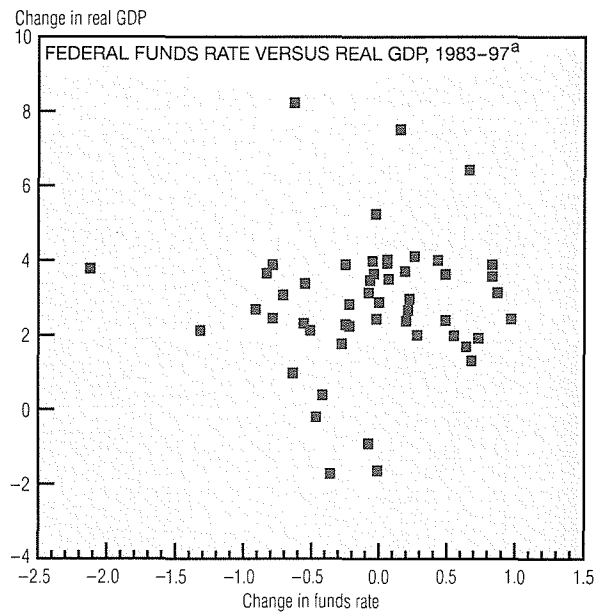
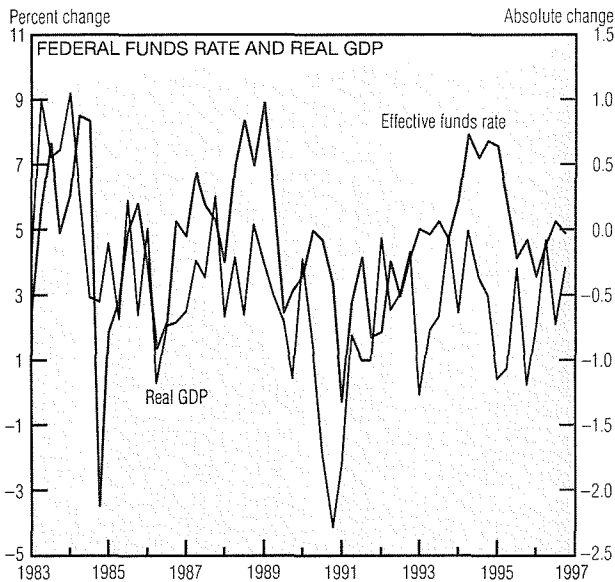
In contrast, the month leading up to the FOMC's March meeting was characterized by a notable increase in interest rates. From February 21 to March 21, the yields on three-month and one-year Treasury constant maturities rose 20 and 34 b.p., respectively, while the yield on the 30-year long bond moved up 37 b.p.

A common interpretation of the FOMC's latest policy move is that the Federal Reserve sought to tighten money market conditions

slightly by driving up interest rates to head off future inflation. However, movements in short-term rates during the past few months suggest another interpretation. If one accepts that interest rates are influenced by a variety of factors apart from the actions of the Federal Reserve, then the recent funds rate increase may be viewed as an effort to keep it in line with other market interest rates, rather than to tighten monetary policy.

*(continued on next page)*

# Monetary Policy (cont.)



a. Points show the relationship between a quarterly change in the federal funds rate and the percent change in GDP over the next four quarters.  
 b. Points show the relationship between a quarterly change in the federal funds rate and the percent change in employment over the next four quarters.  
 NOTE: All data are seasonally adjusted.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Department of Labor, Bureau of Labor Statistics.

One could even argue that a constant funds rate over this period would have represented a slight easing of policy.

Implied yields on federal funds futures, which reflect expectations of future policy, suggest that market participants anticipate further increases in the funds rate over the next several months. Expectations of future policy seem to have changed little over the past month.

Another widespread interpretation of the March policy move is that

the Fed is sacrificing output and employment growth to attain its goal of price stability. While there is little doubt that a large and sudden increase in the funds rate can have substantial negative effects on these two measures (as witnessed by the experience of the early 1980s), it is much less clear that relatively moderate changes in the funds rate lead to opposite movements in output and employment.

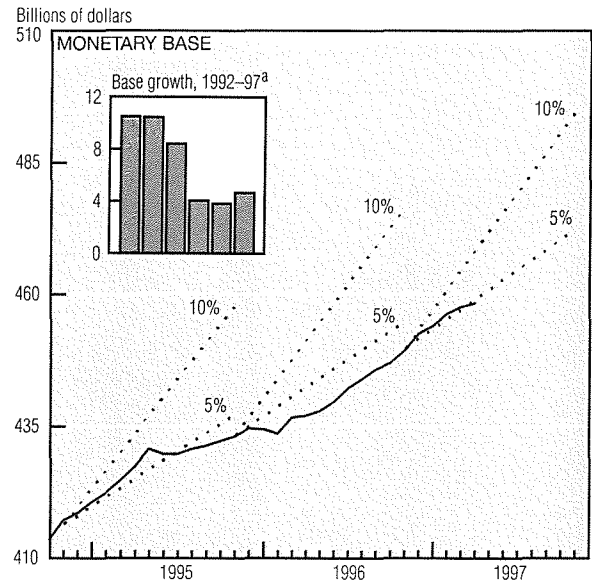
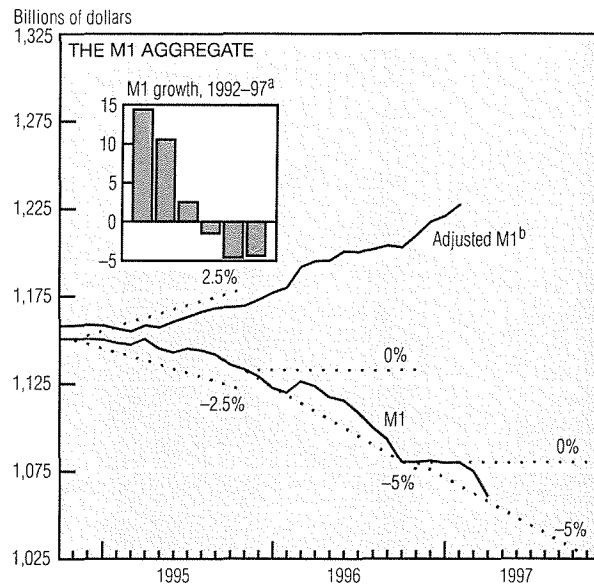
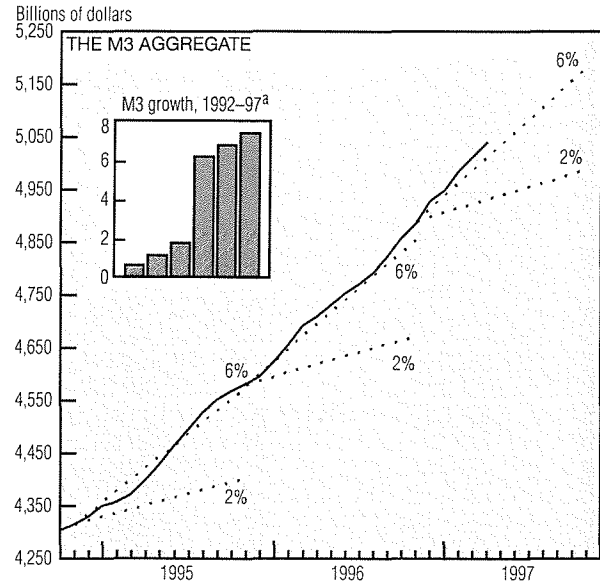
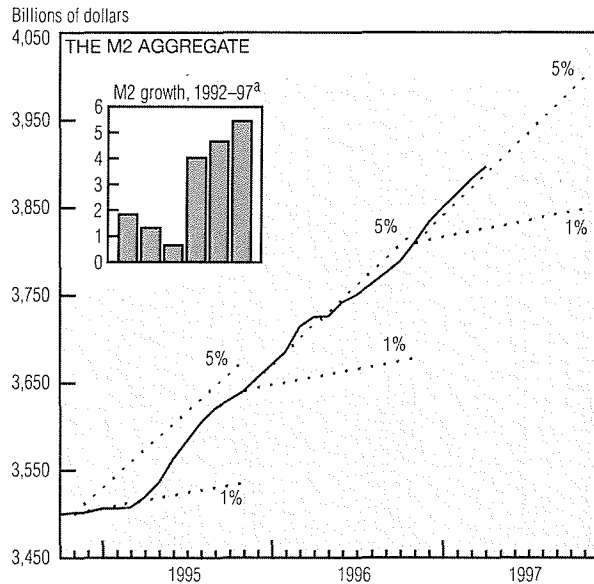
Consider the past 14 years, a period largely without sudden and

substantial movements in the federal funds rate. During these years, there has been no clear relationship between changes in the funds rate, employment, and output. In particular, quarter-to-quarter increases in the funds rate have not been associated with declines in either output or employment over the following year.

Although this fact does not imply that moderate changes in the funds rate have no impact, it does suggest that the relationship between these variables is less obvious than some

*(continued on next page)*

## Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on an estimated April over 1996:IVQ basis.

b. Adjusted for sweep accounts.

NOTE: All data are seasonally adjusted. Last plot is estimated for April 1997. For M1 and the monetary base, dotted lines represent growth ranges and are for reference only. All other dotted lines are FOMC-determined provisional ranges.

SOURCE: Board of Governors of the Federal Reserve System.

reports have stated. Over the last 14 years, fluctuations in output and employment likely resulted in large part from factors other than monetary policy, including changes in fiscal policy, legal regulations, and technology.

Turning to growth in the money stock, the broader aggregates continue to exceed the upper bound of the FOMC's provisional ranges for 1997. From March 1995 to March 1997, M2 and M3 grew at annual rates of 5.2% and 7.1%, respectively.

The monetary base, a narrower measure of money that comprises currency held by the public plus bank reserves, increased 5.7% during the first quarter, up slightly from the roughly 4% pace of 1995 and 1996. However, all of this growth was due to an increase in currency holdings, as total reserves continued its downward trend and fell at an 8.1% annual rate.

M1, which consists primarily of currency and checkable deposits, has continued to fall in recent weeks

after leveling off in late 1996 and early 1997. The declines in both M1 and total reserves over the past few years have generally been attributed to the development of sweep accounts. (These accounts allow banks to lower their required reserves by short-term "sweeping" of deposits from accounts that require reserves to those that do not.) When the M1 data are adjusted to account for sweep activity, the downward trend in the nonadjusted data disappears.