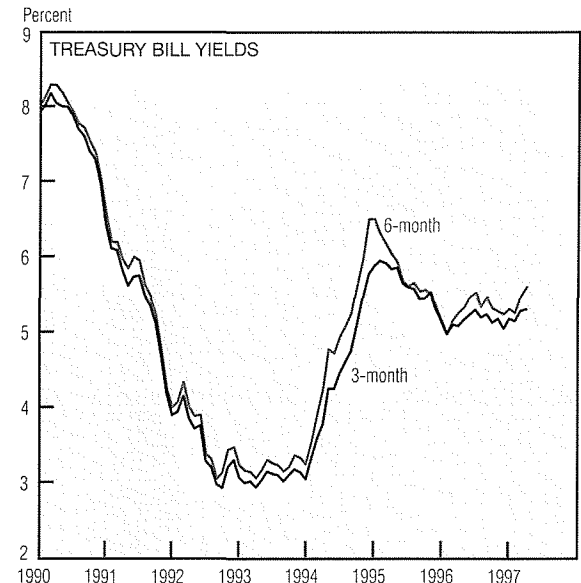
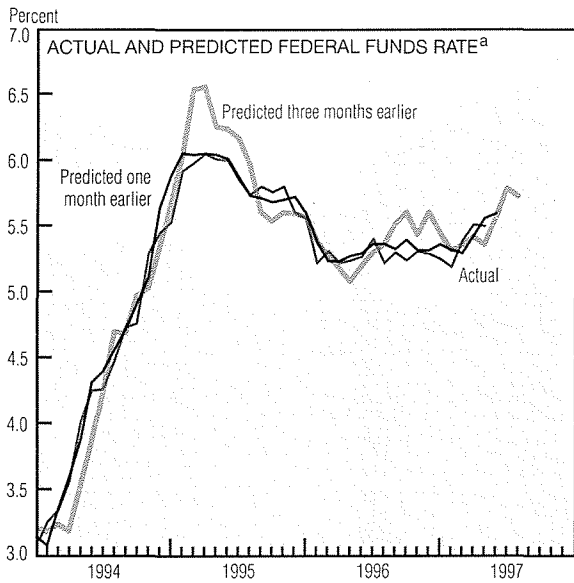
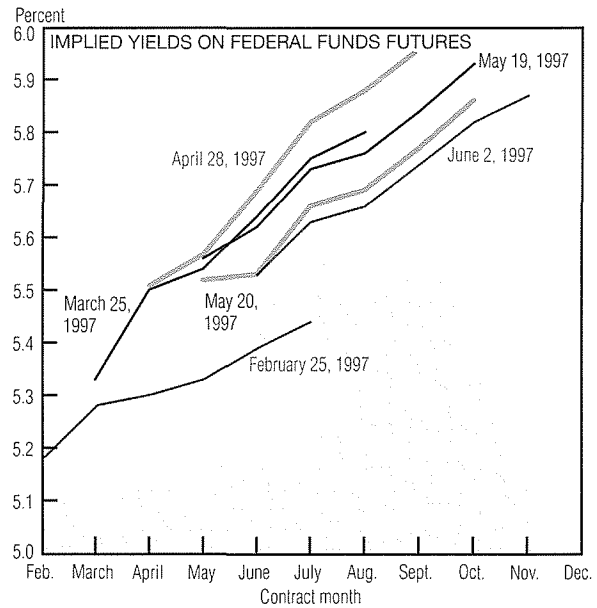
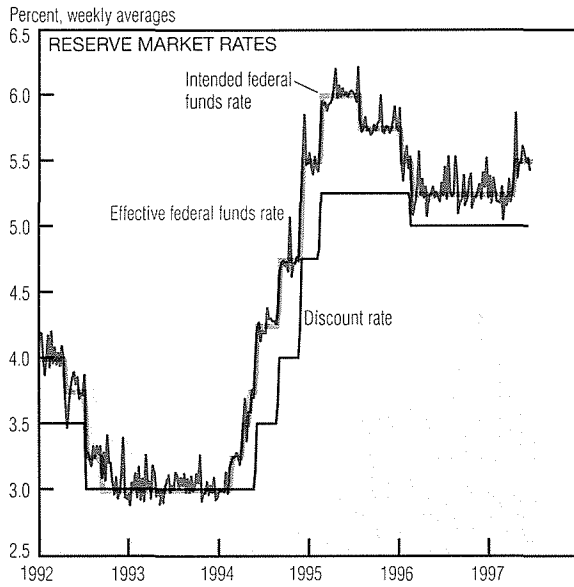


# Monetary Policy



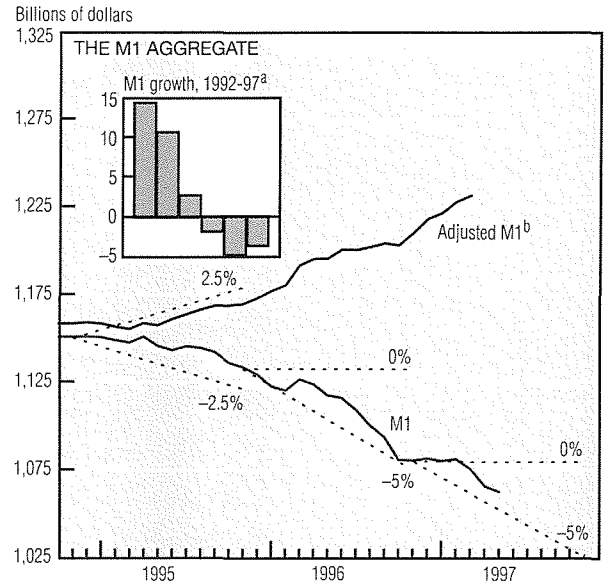
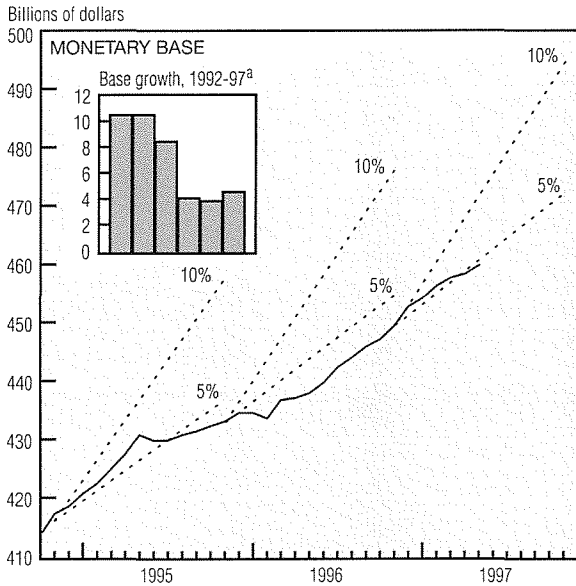
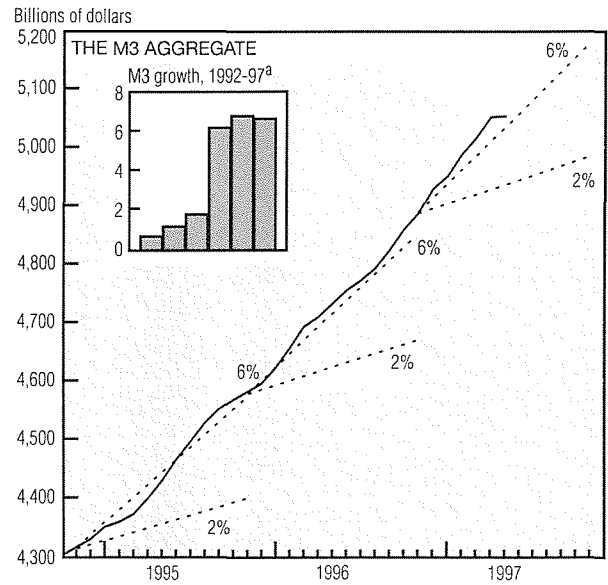
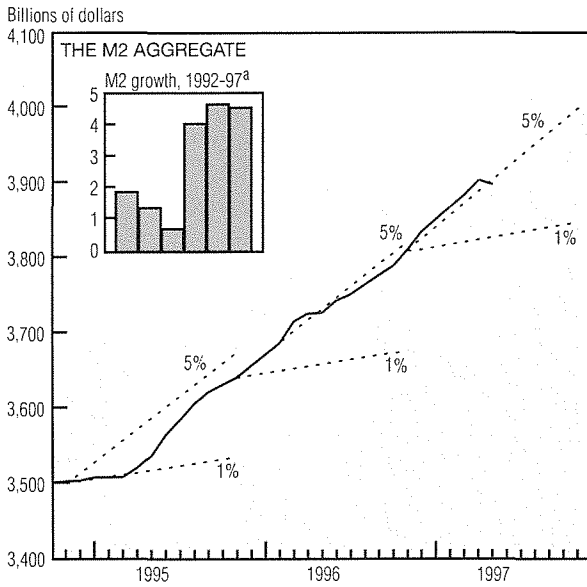
a. Predicted rates are federal funds futures.  
 SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

At its May 20 meeting, the Federal Open Market Committee (FOMC) decided to maintain the existing degree of pressure on the federal funds rate, expecting it to remain around 5.5%. The rate was last increased 25 basis points to its current level at the March 25 meeting, after staying unchanged for nearly 14 months. Financial markets, as represented by the federal funds futures market, had been anticipating another rate increase of 25 points by July, and many market participants had expected an uptick to be announced at the FOMC's May meeting.

The implied yields on federal funds futures prices are reasonably unbiased predictors over horizons of three months or less. The rather abrupt shift in implied yields following the May meeting suggests that the FOMC's decision was a surprise to some. Since then, expectations of a rate increase have shifted outward, and financial markets now expect a 25-basis-point rise by September. The FOMC will reconvene July 1. Treasury bill yields have edged up since the beginning of the year, with the 3-month and 6-month yields standing at 5.3% and 5.6%, respectively. This is above levels

seen in the second half of 1992 and in 1993, but well below those that prevailed early in the decade. The M2 and M3 aggregates decelerated noticeably from the end of April through the first few weeks of May. This brought M2 growth below its provisional range of 5%, which was announced in February during Chairman Alan Greenspan's semi-annual report to Congress (the Humphrey-Hawkins testimony). Although the M3 aggregate has slowed significantly since April, it continues to exceed its provisional range of 6%. The 1997 annualized growth rates for *(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 May over 1996:IVQ basis.  
 b. Adjusted for sweep accounts.  
 NOTE: All data are seasonally adjusted. Last plot is estimated for May 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.

M2 and M3 are currently 4.5% and 6.6%, respectively. Just last month, annualized growth rates stood at 5.8% for M2 and 7.9% for M3.

The deceleration resulted from the settling of tax liabilities that were due in April. The recent bull market in stocks, which created a windfall for investors in 1996, forced them to build up payments accounts early this year to cover larger-than-normal tax bills. The March federal funds rate increase, combined with the release of deposits held to meet tax li-

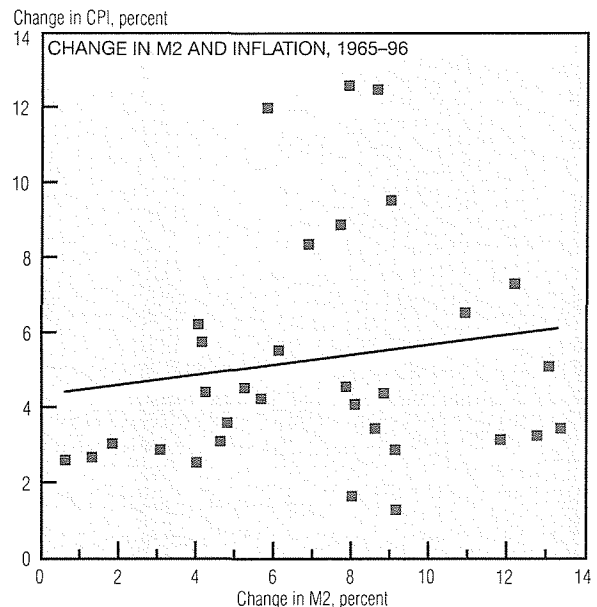
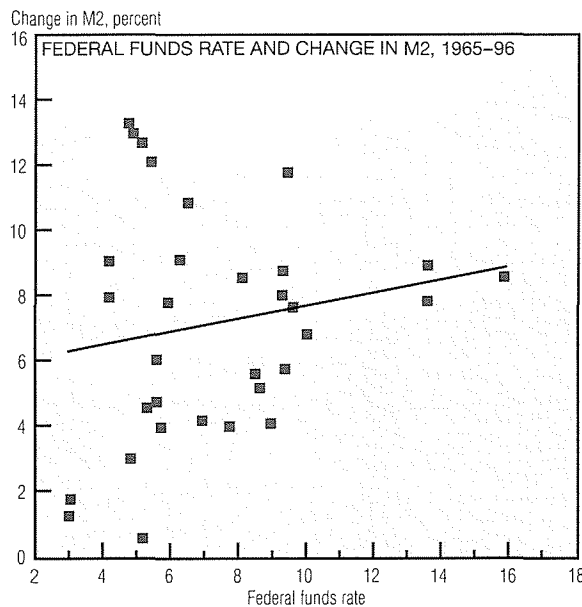
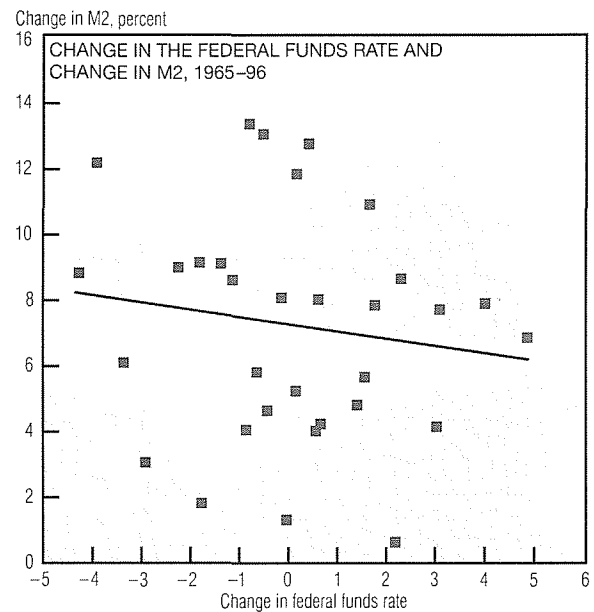
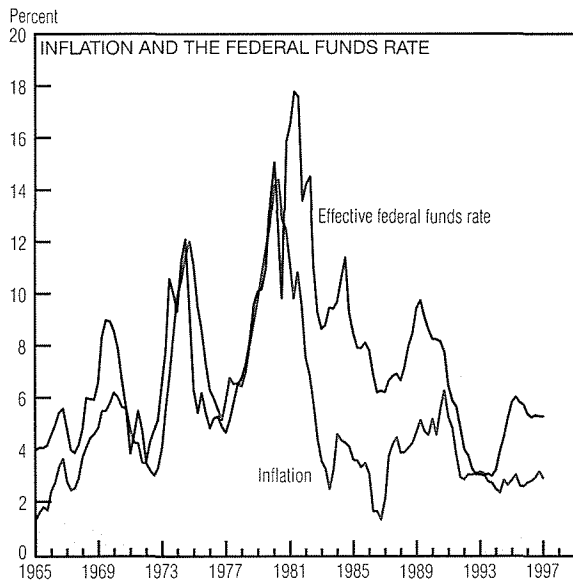
abilities, should allow M2 growth to finish the year within its provisional range and should help bring M3 growth more into line with its provisional range.

Growth in the monetary base, a narrower measure consisting of currency held by the public plus bank reserves, slowed from a 4.6% annualized rate in April to May's 4.5% rate. The M1 aggregate continues to fall at a 3.4% annualized rate. The stabilization of M1 between 1996:IVQ and 1997:IQ convinced

many that sweep accounts were becoming saturated. However, money market deposit accounts (MMDAs) continue to grow with the proliferation of sweep accounts. These allow banks to economize on reserve balances by "sweeping" excess household checkable deposits (which are reservable) into MMDAs (which are not). These arrangements account for the continued unexpected strength in MMDAs and the weakness in M1, which includes checking

*(continued on next page)*

## Monetary Policy (cont.)



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

accounts but not MMDAs. When adjusted for sweep accounts, M1 continues to rise.

It is generally believed that the federal funds rate must be increased if inflation is to be lowered. Yet the correlation between inflation and the funds rate is positive, suggesting a more complicated connection. The reasons for this positive relationship are that the federal funds rate is also positively related to money (M2) growth—and faster money growth is a causal factor in future inflation.

How, then, can increasing the federal funds rate lower inflation? The

answer is that while the level of the funds rate is associated with high inflation, increases in this interest rate are associated with lower M2 growth. Although raising the funds rate lowers inflation, once inflation has decreased, the funds rate must be brought back down.

Like all nominal interest rates, the federal funds rate consists of both a real rate and an expected inflation component. In the short term, expectations are fixed, and the monetary authority controls the funds rate by changing the real rate. To increase the real—and hence the nominal—funds rate,

money growth is slowed, which brings down inflation.

Yet, in the long term, everything is reversed, since ultimately the only way the monetary authority can control the funds rate is by changing expected inflation. Therefore, to permanently reduce inflation, the monetary authority should follow the initial round of tightening with reductions in the funds rate, as inflation starts to fall. The timing of these subsequent reductions is crucial: If they are not anticipated, money growth will increase, undermining policymakers' anti-inflation efforts.