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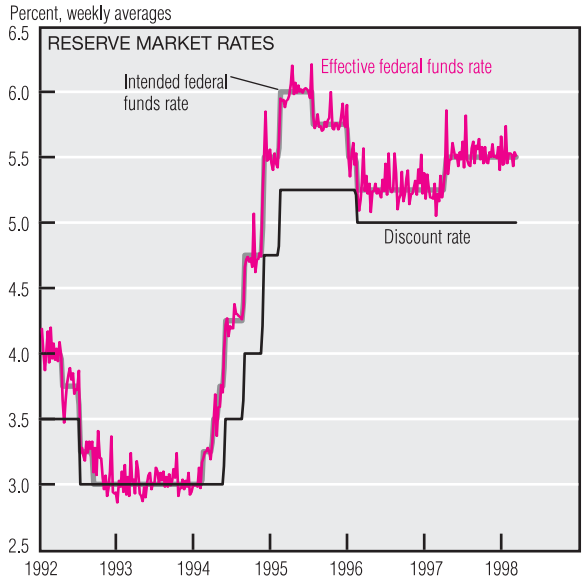
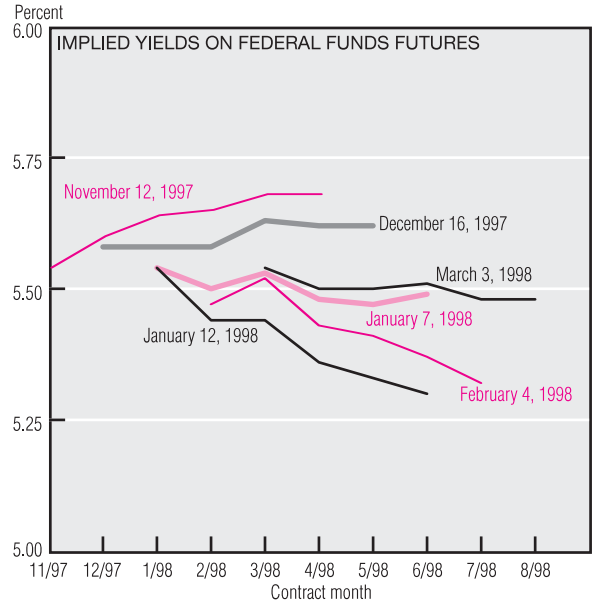
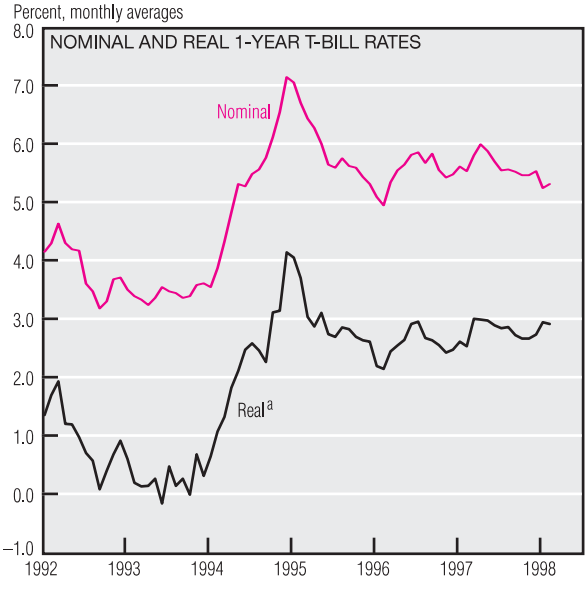
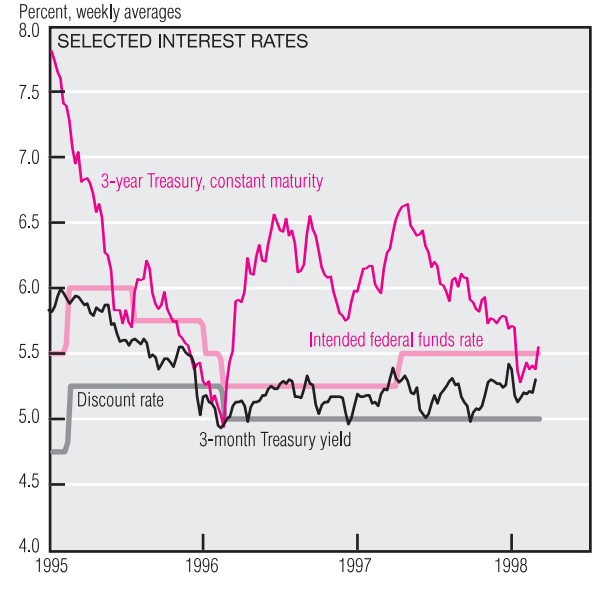
# Monetary Policy




a. Nominal 1-year Treasury less 1-year inflation expectations as measured by the University of Michigan's Survey of Consumers.
SOURCES: Board of Governors of the Federal Reserve System; the University of Michigan; and the Chicago Board of Trade.

At the conclusion of its February meeting, the Federal Open Market Committee (FOMC) indicated that no action had been taken to change the intended federal funds rate. Since February 1996, the Committee has altered the funds rate only once—a 25-basis-point increase (from 5¼% to 5½%) in March 1997.

The relative absence of deliberative action in recent years does not necessarily mean that policy has been unchanged. Indeed, gauging the Fed's policy stance on the basis of interest rates is a tricky business. Since early 1996, for instance, inflation expectations have been trending down. This implies that even though nominal interest rates have remained relatively steady, real interest rates (the nominal rate less expected inflation) have been drifting up.

Furthermore, the upward shift in real interest rates by itself need not indicate that policy has become more restrictive. Real interest rates can rise when the economy faces a surge in investment opportunities that boosts the rate of return on new business investment. The economy's recent strength has been characterized by just such a situation. A tremendous increase in business investment in recent years has raised the demand for credit, putting upward pressure on real interest rates. Thus, higher interest rates may be interpreted as being associated with an *accommodative* policy.

The federal funds futures market reveals expectations about the level of the fed funds rate for a given contract month. As of early March,

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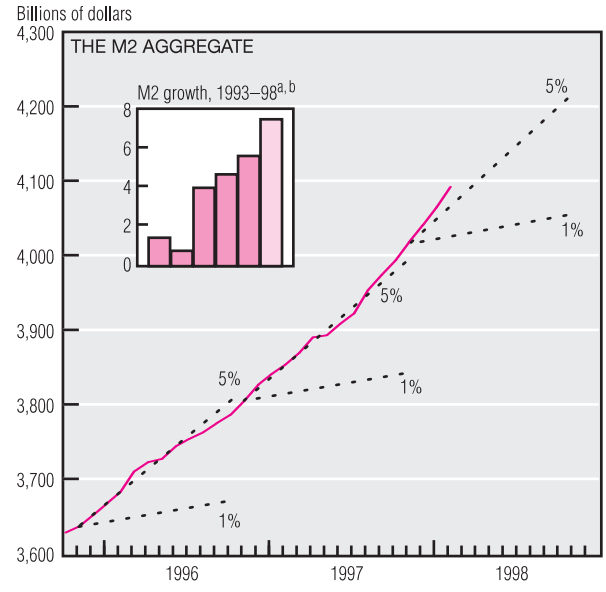
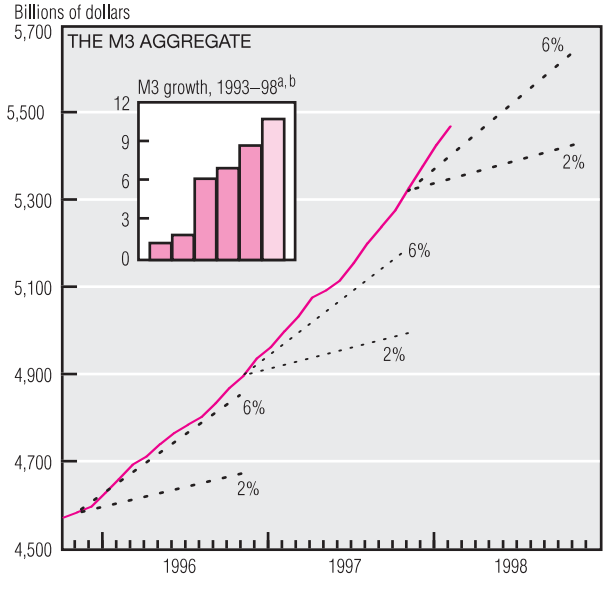
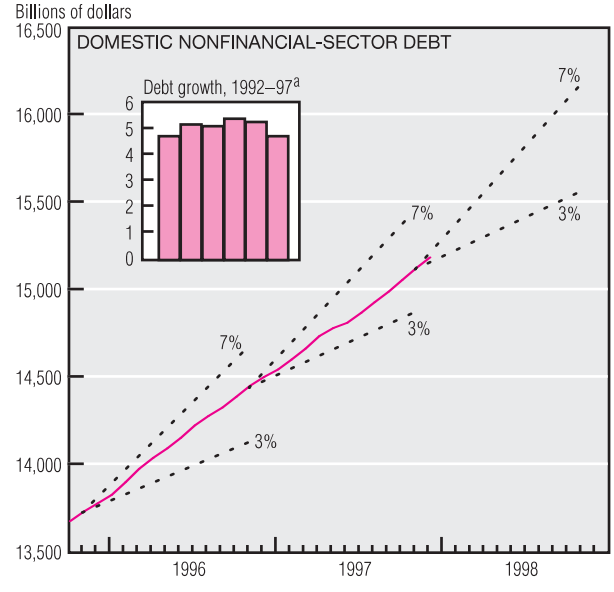
# Monetary Policy (cont.)

**Economic Projections for 1998**
**(Percent)**

| Indicator | FOMC Range | FOMC Central tendency | Administration |
|---|---|---|---|
| **Change, IVQ over IVQ** | | | |
| Nominal GDP | 3½–5 | 3¾–4½ | 4.0 |
| Real GDP | 1¾–3 | 2–2¾ | 2.0 |
| Consumer Price Index | 1½–2½ | 1¾–2¼ | 2.2 |
| **Average level, IVQ** | | | |
| Civilian unempl. rate | 4½–5 | ≈ 4¾ | 5.0 |




a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.
b. Annualized growth rate for 1998 is based on an estimated February over 1997:IVQ basis.
NOTE: All data are seasonally adjusted. Last plot is estimated for February 1998. Dotted lines represent FOMC-determined provisional ranges.
SOURCE: Board of Governors of the Federal Reserve System.

these futures prices implied an expectation of no change in the funds rate through this summer. During 1998, the Blue Chip consensus forecast calls for a slowdown in economic activity from last year's vigorous 3.9% pace. This suggests that the public interprets the stance of policy as consistent with a deceleration in output.

In his February 24 testimony before Congress, Federal Reserve Chairman Alan Greenspan presented the FOMC's economic projections for 1998. The Committee expects a moderation in real GDP growth to around $2\frac{3}{8}$%, while inflation is seen rising slightly from its 1997 pace to around 2%. The slowdown in economic activity is largely attributed to the financial turmoil in Southeast Asia, which is expected to dampen foreign demand for U.S.-produced goods. At the same time, sharply lower Asian currency prices are expected to counteract domestic price pressures, both directly—through declining import prices—and indirectly—through competition in the traded-goods sector.

In establishing provisional ranges for the monetary and debt aggregates, the FOMC recognized the considerable uncertainty surrounding the velocities of these measures. Historically, M2 velocity—simply the ratio of nominal GDP to M2—has tended to return to some modestly increasing trend level. This implies that over long periods, nominal GDP tends to grow at approximately the

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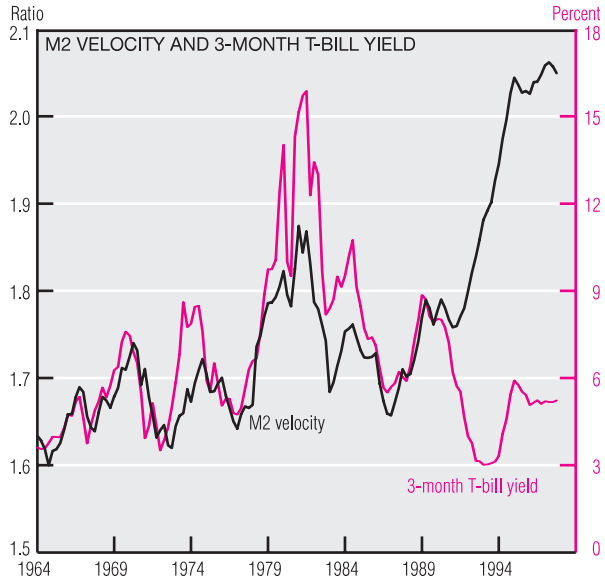
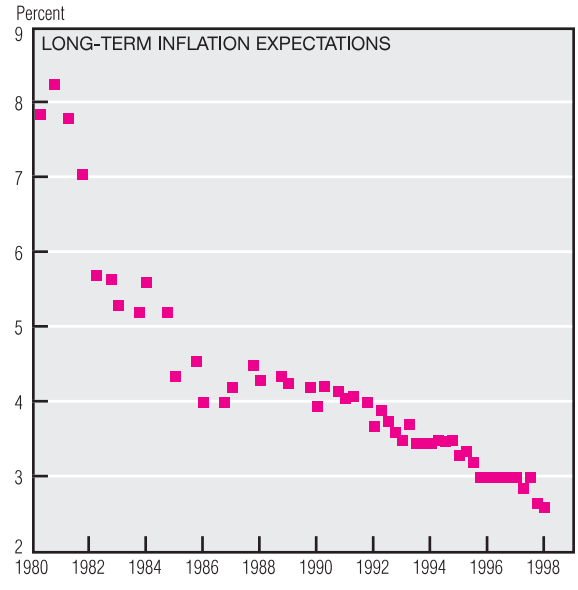
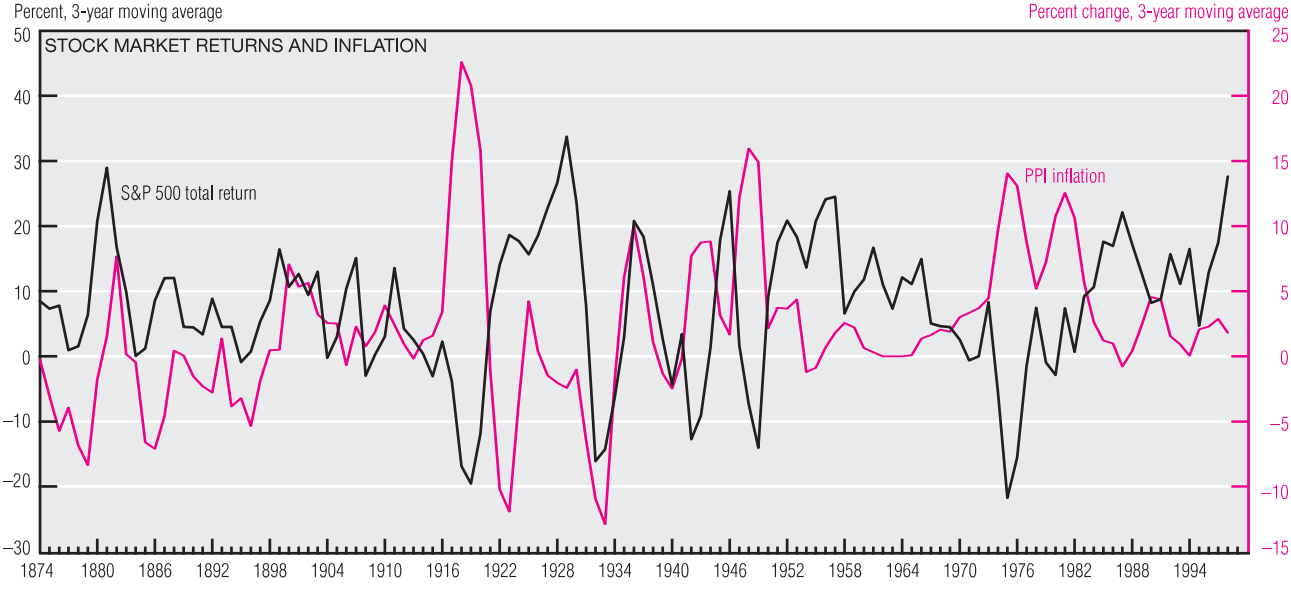
# Monetary Policy (cont.)




SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; and Standard & Poor's Corporation.

same rate as M2. In the short run, by contrast, velocity tends to vary with interest rates. The early 1990s witnessed a different pattern, however. M2 velocity rose unexpectedly, although there was no commensurate increase in interest rates. This anomaly persisted until 1994, when M2 resumed behavior consistent with its historical relationship to spending. In light of the uncertainty surrounding the velocity of money, the FOMC sets ranges not as projections for expected money growth, but rather as benchmarks for M2 and M3 behavior consistent with sustained price stability, assuming velocity moves in line with its pre-1990 experience.

Despite the difficulties the Committee faces in determining the stance of policy, it has made substantial progress in achieving its long-standing goal of price stability. Since 1980, inflation has declined from double-digit rates to less than 2%. Furthermore, survey data reveal that the FOMC has earned substantial credibility in its fight to maintain lower inflation over the long term.

Progress in achieving price stability laid the foundation for the recent sustained period of economic prosperity. Indeed, total stock market returns have been spectacular since 1995. This seems less surprising when we observe the historical relationship between stock prices and inflation. The stock market tends to perform best when inflation is moderate. By contrast, poor stock market performance is associated with high inflation or extreme deflation.