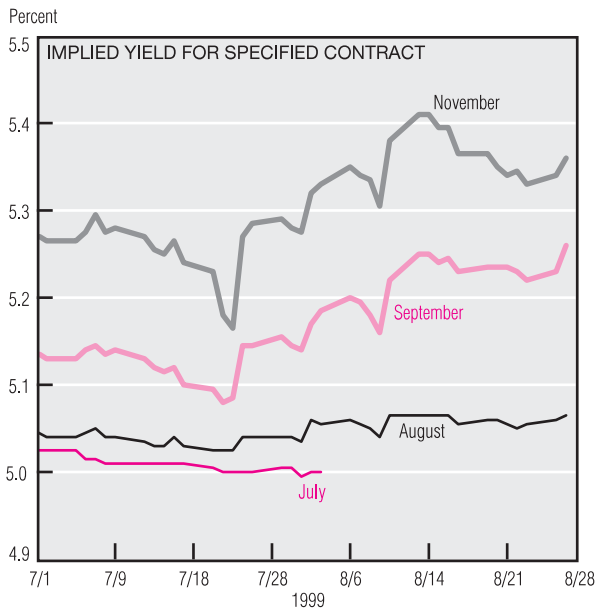
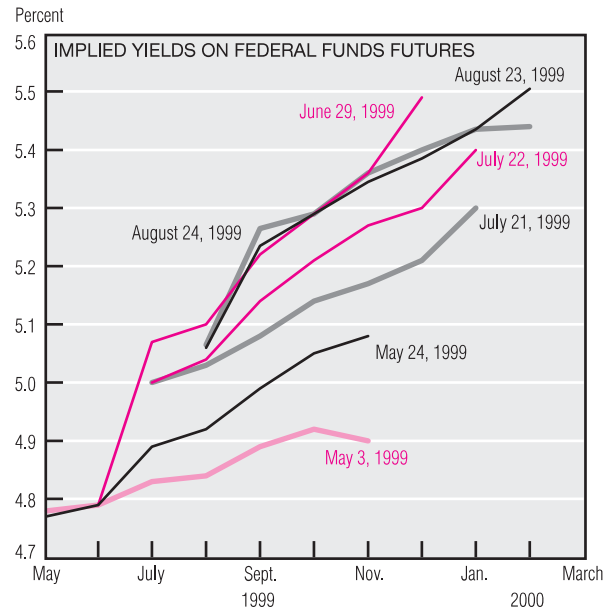
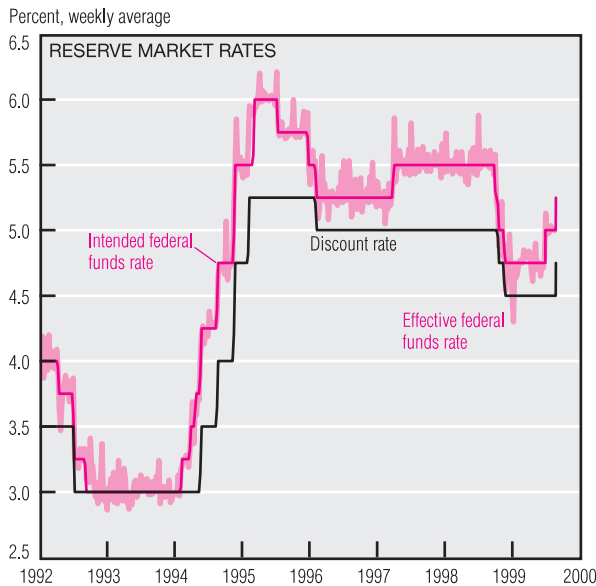


# Monetary Policy



a. Constant maturity.

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

On August 24, the Federal Open Market Committee (FOMC) raised the intended federal funds rate and the discount rate by 25 basis points each—to 5.25% and 4.75%, respectively. Although financial markets generally had anticipated the move just prior to the FOMC decision, expectations about the future path of the federal funds rate had fluctuated substantially since the Committee's previous meeting.

In light of the tilt announced in the May directive, market participants had expected the increase at

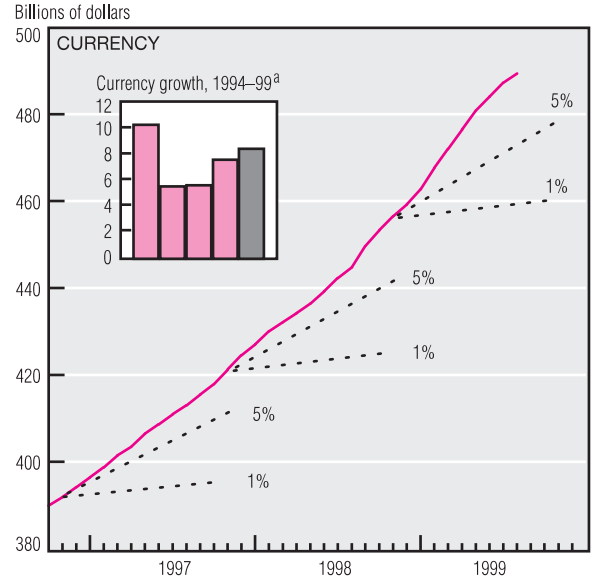
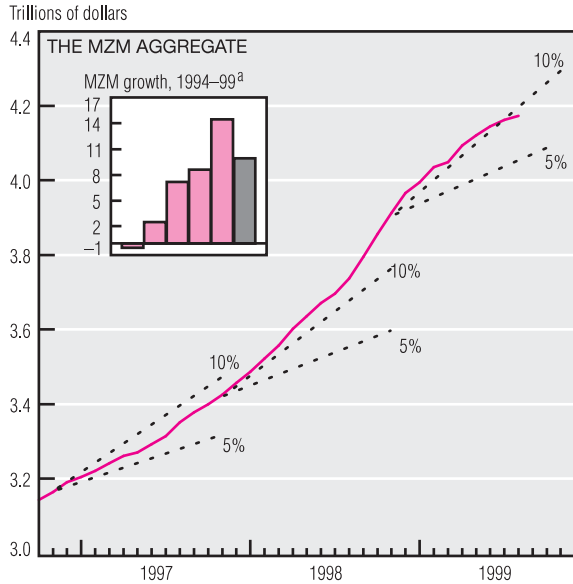
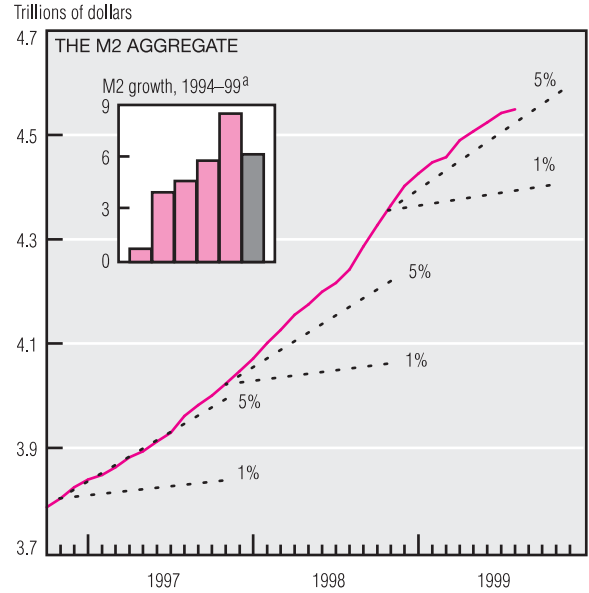
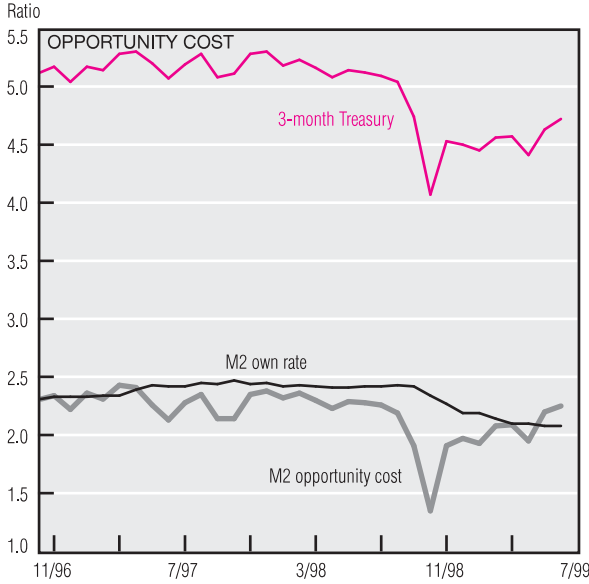
the June 29 meeting; however, adoption of a neutral directive at that meeting seemed to come as a surprise. In the wake of the June announcement, implied yields on fed funds futures dropped sharply across contract months.

The expected funds rate trajectory began drifting upward after Chairman Alan Greenspan's testimony to Congress on July 22, which emphasized the FOMC's resolve to preempt inflation by acting "promptly and forcefully so as to preclude imbalances." The effect is clearly evidenced by the sharp

break in the September and November contracts at this date. Subsequent data appeared to convince market participants that inflationary pressures were building, particularly in the labor market, and implied yields continued to drift upward as the meeting date neared. The policy announcement of rate increases had virtually no impact in this market. Consistent with rising expectations for policy firming, short-term rates rose over the period between meetings.

(continued on next page)

# Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 1999 growth rates for M2, MZM, and currency are calculated on an estimated July over 1998:IVQ basis.  
 NOTE: Data are seasonally adjusted. Last plots for M2, MZM, and currency are estimated for August 1999. Dotted lines for M2 are FOMC-determined provisional ranges. All other dotted lines represent growth in levels and are for reference only.  
 SOURCE: Board of Governors of the Federal Reserve System.

The demand for M2 is inversely related to the opportunity cost of holding M2—commonly measured as the difference between the three-month Treasury bill rate and the average of own rates paid on M2 components. Since M2 own rates respond only sluggishly to market conditions, M2 opportunity cost initially moves in tandem with market rates. Thus, the three consecutive FOMC rate cuts last fall sharply reduced M2 opportunity cost, inducing an increase in M2 growth around

year's end. The recent upward drift in opportunity cost associated with the reversal in market rates is beginning to dampen M2 growth.

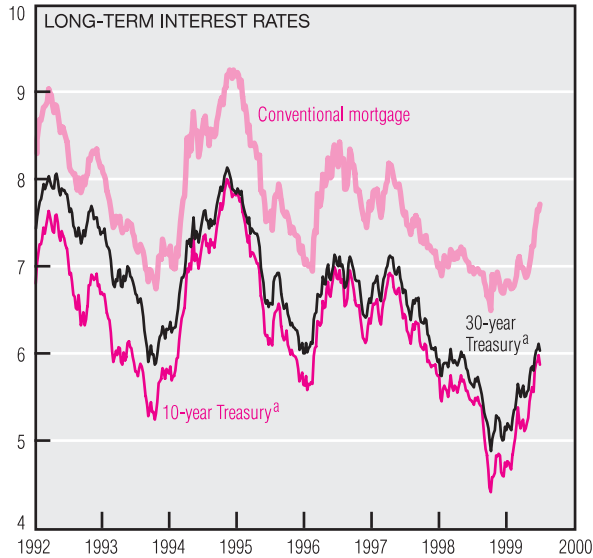
The MZM money measure equals M2 minus small time deposits but includes institutional money-market mutual funds. It is similarly affected by changes in short-term interest rates. Because it comprises relatively safe, liquid instruments, it has served as a haven for funds, particularly during periods of heightened uncertainty such as last fall. Cur-

rency growth is expected to remain strong over the rest of the year, as the public prepares for contingencies related to Y2K.

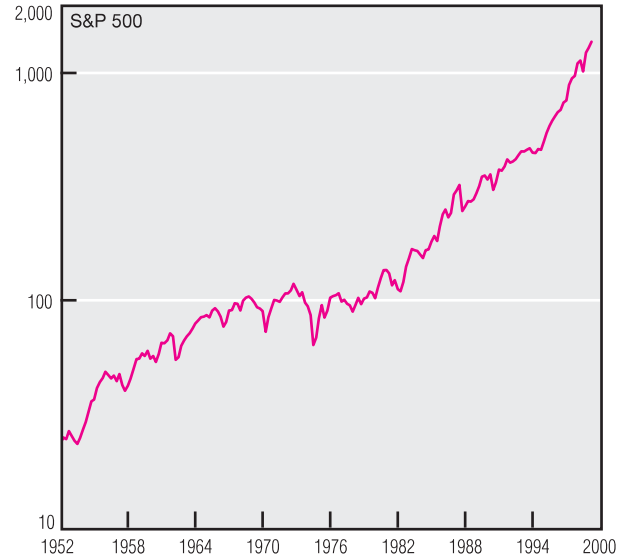
When policy changes direction, capital markets often become unsettled. In February 1994, for example, the FOMC initiated a series of fed funds rate increases after several years of stable or falling target levels. Long-term interest rates jumped sharply—almost 200 basis points in early 1994. The two recent changes  
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## Monetary Policy (cont.)

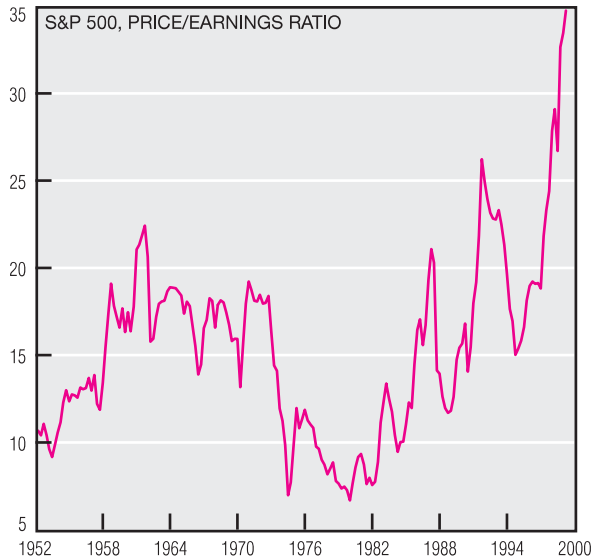
Percent, weekly average



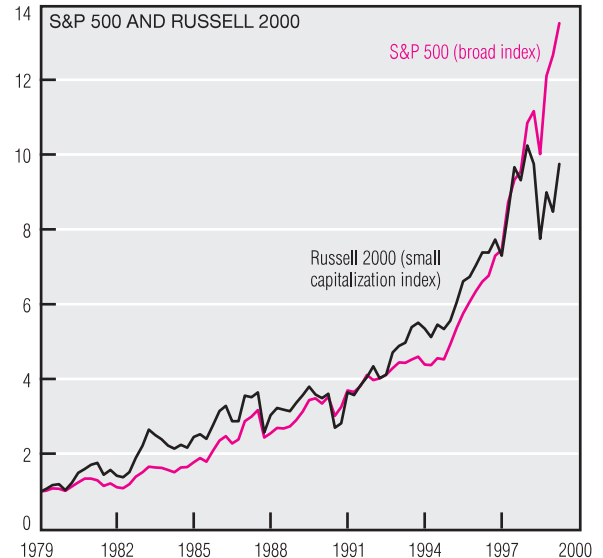
Index, 1941–43 = 10 (log scale)



Ratio



Index, January 1979 = 1



a. Constant maturity.

SOURCES: Board of Governors of the Federal Reserve System; Standard & Poor's Corporation; and Bloomberg Financial Information Services

in the intended fed funds rate were the first consecutive increases in more than four years. Though long-term interest rates increased, the effect has been relatively muted.

Nevertheless, long rates have drifted up substantially. Perhaps surprisingly, the upward drift in yields on fixed-income securities has not affected the stock market adversely. To some extent, stock prices have been bolstered by good news on profits. Fundamentally, a stock's price is determined as the dis-

counted value of its expected future dividends. Future dividends, in turn, derive from future earnings.

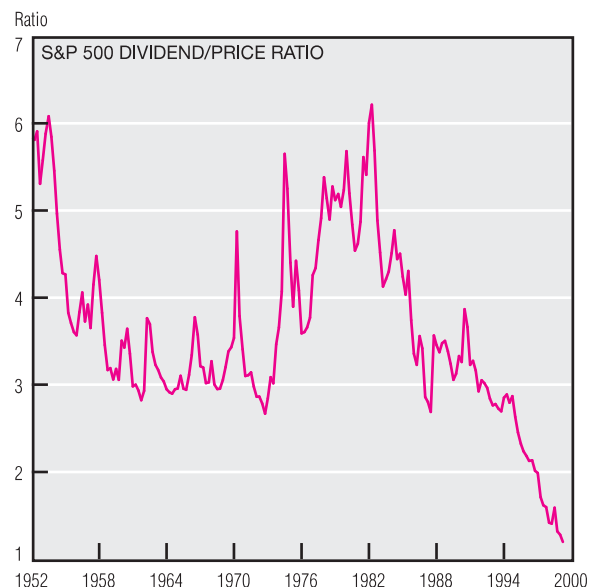
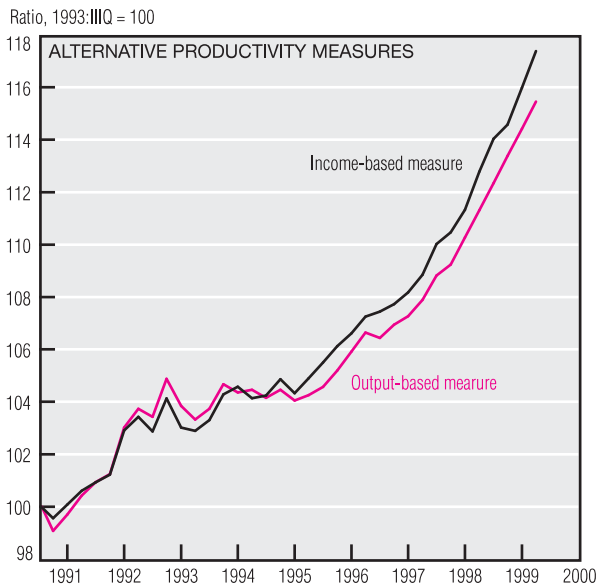
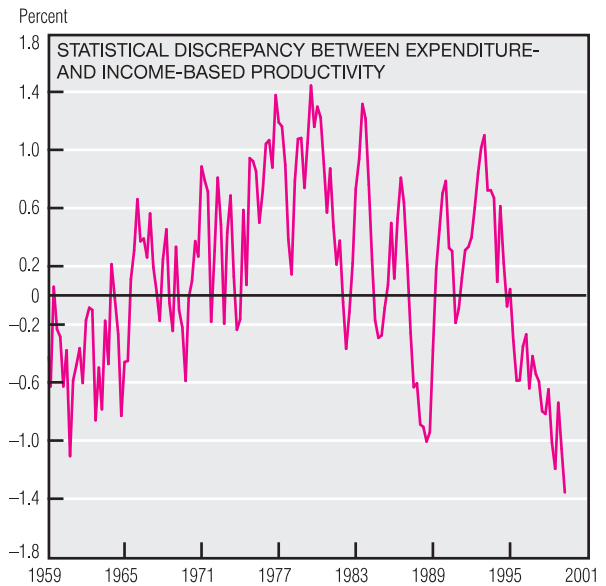
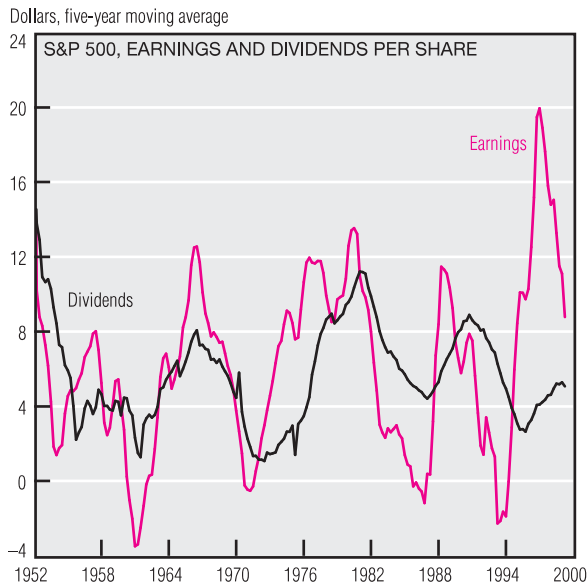
When prospects for earnings growth are good, stock prices tend to rise. The price/earnings (P/E) ratio—simply the stock price divided by earnings per share—gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and hence the more earnings growth they are expecting. The P/E of S&P 500 stocks has been

rising over the past two years, approaching historically high levels.

The one clearly extraordinary fact associated with the rise in stock prices has been the sustained earnings growth over much of the decade. Analysts' earnings projections reveal an expectation of continued benefits from corporate cost cutting and innovation. Moreover, it is argued that a large portion of business outlays, currently expensed, should be amortized so that

*(continued on next page)*

## 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; Standard & Poor's Corporation; and Bloomberg Financial Information Services.

the returns that they produce would be more accurately reflected as earnings over time. If the trend in expensed items that should be capitalized is growing faster than reported earnings, capitalizing these items will generally accelerate measured earnings.

Pessimists about the sustainability of such strong earnings point to measured productivity growth which, while strong, is less extraordinary than earnings. Optimists argue that traditional measures understate true productivity growth and point to statistical discrepancies.

One source of potential error is the official measure of gross domestic product (GDP), which is obtained by summing the dollar value of expenditures on consumption, investment, government purchases, and the value of net exports. It is conceivable that some nominal expenditures are not recorded.

As a cross-check, the Commerce Department's Bureau of Economic Activity (BEA) calculates both expenditure- and income-based measures. The BEA designates the expenditure-side estimate as the official one but publishes the discrepancy between

the two measures. Since the last business-cycle peak, the income-based measure of productivity expanded about 0.2% faster per year than the official measure. Optimists also argue that imperfections in price measurement tend to understate true productivity. As Chairman Greenspan recently noted, "We no longer have the luxury to look primarily to the flow of goods and services, as conventionally estimated, when evaluating the macroeconomic environment in which monetary policy must function."