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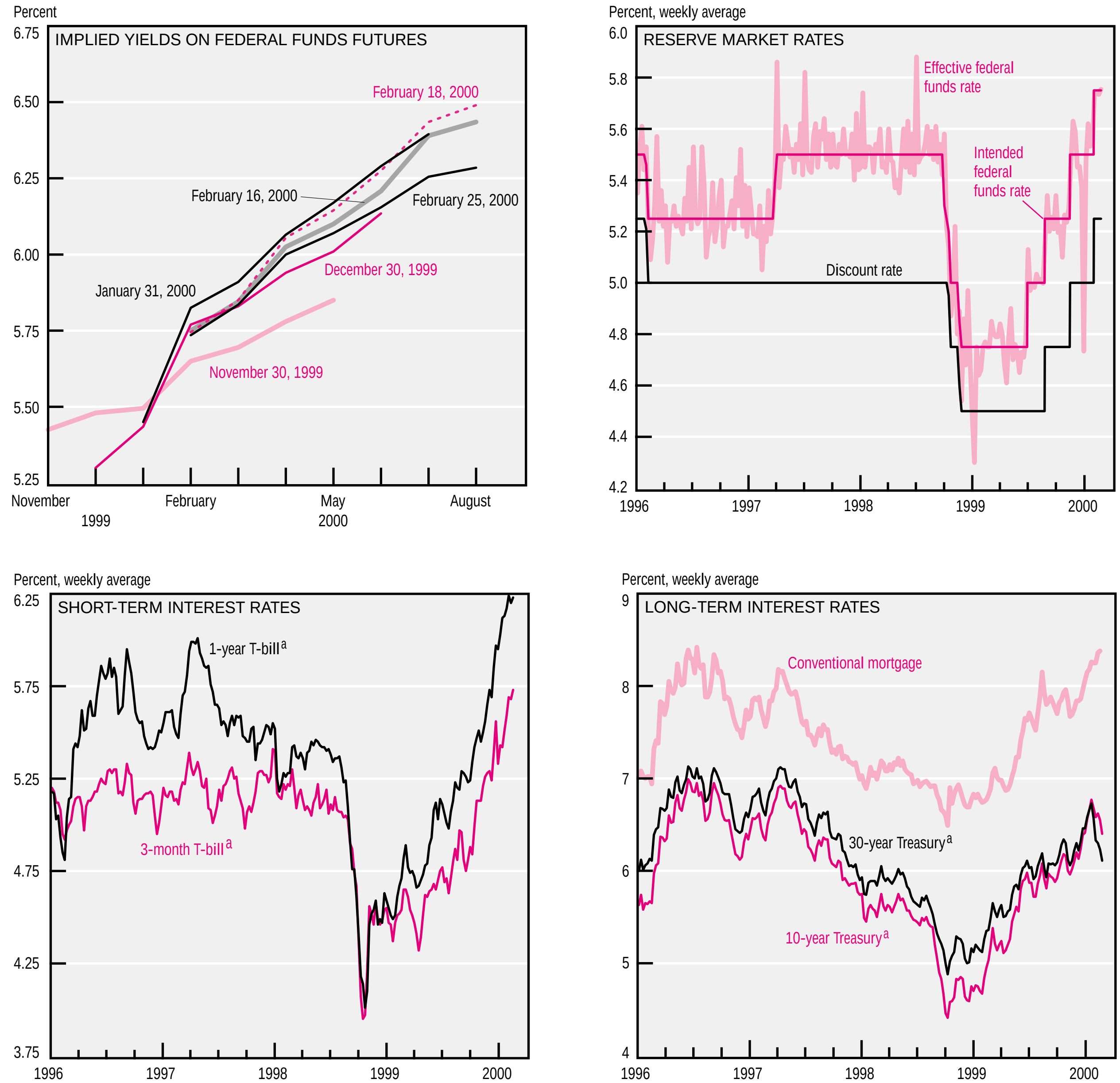
Monetary Policy



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

On February 17, the Board of Governors of the Federal Reserve System submitted its semiannual Monetary Policy Report (or Humphrey–Hawkins Report) to the Congress, as mandated by the Full Employment and Balanced Growth Act of 1978. On the same day, Federal Reserve Chairman Alan Greenspan testified on the report to the House of Representatives' Committee on Banking and Financial Services.

Chairman Greenspan commented that the economy's strong performance in 1999 was "unprecedented in my half-century of observing the American economy." He noted that continued acceleration in productivity is a key factor in this economic strength. However, in a cautionary note that drew a great deal of media attention, he also pointed out that "those profoundly beneficial forces driving the American economy to competitive excellence are also engendering a set of imbalances that, unless contained, threaten our continuing prosperity."

Despite the media fanfare, the chairman's cautionary remarks did not cause any strong reaction in implied yields on federal funds futures, which are often used as a proxy for market participants' expectations about the future path of policy. The implied yield curve shifted upward only slightly following his testimony, and has since fallen back below pretestimony levels. Apparently, market participants had already built in expectations of significant future interest rate increases, and the chairman's testimony was largely in line with those expectations. As of February 25, the August contract traded at 6.26%, 51 basis points (bp) above the current intended federal funds rate of 5.75%.

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Economic Indicators (percent)

	1999 Actual	Projections for 2000[b] Range	Central tendency
Nominal GDP[c]	5.9	5-6	5¼-5½
Real GDP[d]	4.2	3¼-4¼	3½-3¾
PCE chain-type price index[c]	2.0	1½-2 ½	1¾-2
Civilian unemployment rate[e]	4.1	4-4¼	4-4¼

Growth Ranges for Monetary and Debt Aggregates (percent)

	1998	1999	2000
M2	1-5	1-5	1-5
M3	2-6	2-6	2-6
Debt	3-7	3-7	3-7

a. Constant maturity.
b. By Federal Reserve governors and Reserve Bank presidents.
c. Change, fourth quarter to fourth quarter.
d. Chain-weighted change, fourth quarter to fourth quarter.
e. Average level, fourth quarter.
SOURCE: Board of Governors of the Federal Reserve System.

Beginning on June 30, 1999, the Federal Open Market Committee (FOMC) raised the intended rate a full percentage point through a series of four 25-bp increments. The first three increases can be interpreted as “taking back” the rapid 75 bp decrease associated with concerns about international financial markets that prevailed in the second half of 1998. The latest 25 bp increase, on February 2, marked the first time the intended rate exceeded the level that held throughout 1997 and most of 1998.

Recent increases in the intended federal funds rate may be viewed as responses to increases in market interest rates. Over essentially the same period as the increases in the intended rate (June 25, 1999–February 4, 2000), the 3-month Treasury and the 1-year Treasury rates rose 94 bp and 110 bp, respectively. Furthermore, recent changes in the federal funds rate substantially lagged increases in other interest rates, lending some credence to this view (although plausible alternative stories could be told).

Long-term interest rates show a similar pattern. As of February 18, the 10-year Treasury bond yield reached 6.55%, up 57 bp since June 25, 1999. Rates on 30-year conventional mortgages have risen 75 bp over the same period. In contrast, the 30-year Treasury yield for February 18 of 6.23% is only 12 bp higher than it was on June 25, 1999. However, supply and demand factors may be affecting the yield on 30-year Treasury bonds, causing the

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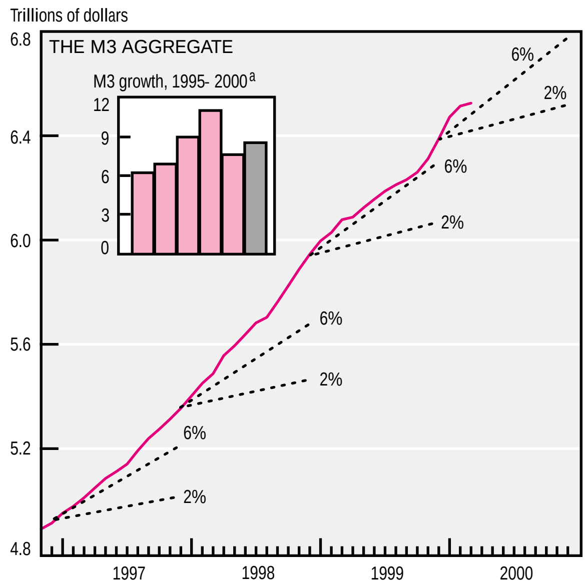

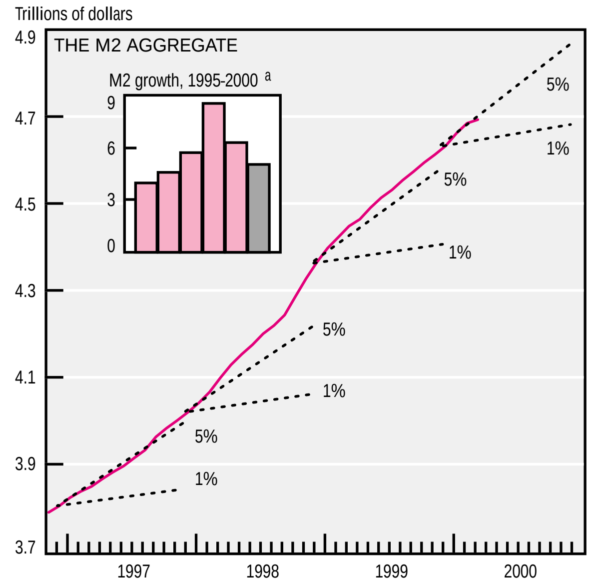

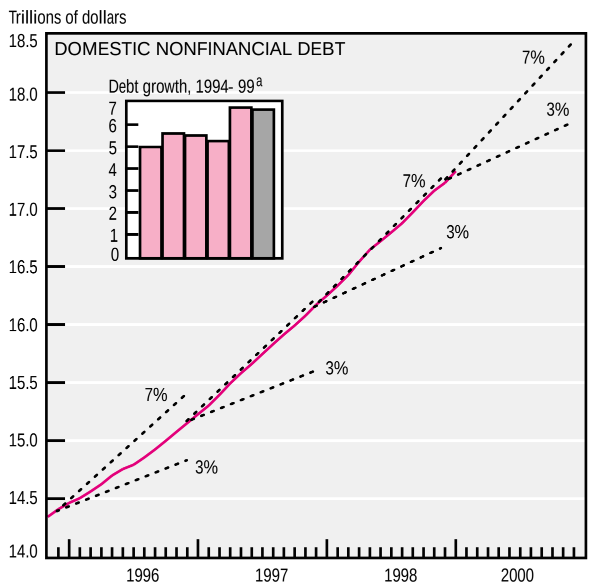

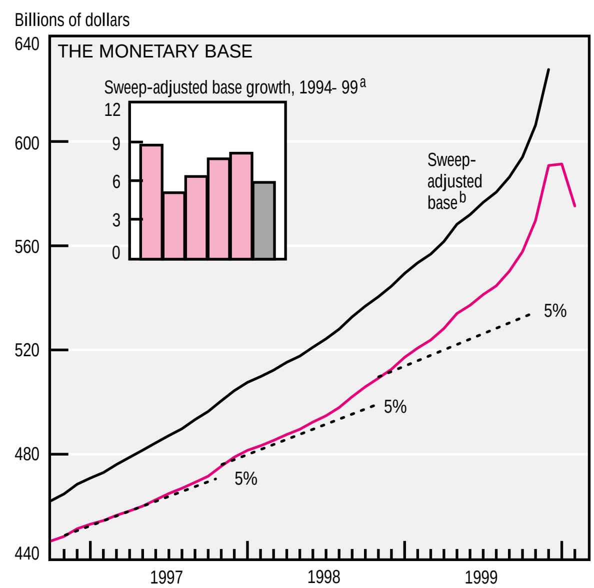

a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.

b. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts.

NOTE: Data are seasonally adjusted. Last plots for M2, M3, and the monetary base are estimated for February 2000. Last plots for domestic nonfinancial debt and the sweep-adjusted base are December 1999. Dotted lines for M2, M3, and debt are FOMC-determined provisional ranges. All other lines represent growth in levels and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

30-year rate to fall below the 10-year rate.

On average, the intended federal funds rate tends to move with short- and long-term interest rates, partly because the underlying rate of inflation is a common factor in determining all interest rates. However, daily data show that changes in the federal funds rate can be associated with no change in market interest rates—and sometimes with changes in the opposite direction. The simplistic and oft-cited view that an increase in the federal funds rate translates directly into same-sized increases in rates on mortgages and car loans is simply not borne out by the data.

The Humphrey–Hawkins report contains economic projections for 2000. Members of the Board of Governors and Federal Reserve Bank presidents expect another strong year. The central tendency of projections for real GDP growth is $3^{1}/_{2}$%–$3^{3}/_{4}$% for inflation (as measured by the Chain-Type Price Index for personal consumption expenditures), the central tendency is $1^{3}/_{4}$%–2%. The unemployment rate is expected to be 4%–$4^{1}/_{4}$% in the fourth quarter of the year.

The report also contains the monetary growth ranges provisionally adopted on July 28 and confirmed at the February 2 meeting. The ranges are intended to reflect conditions of price stability and historical velocity relationships, not to serve as guides for policy. The report states that “the Committee still has little confidence that money growth within any particular range selected for the year would be associated with the economic performance it expected or desired,” but also notes that “the Committee believes that money

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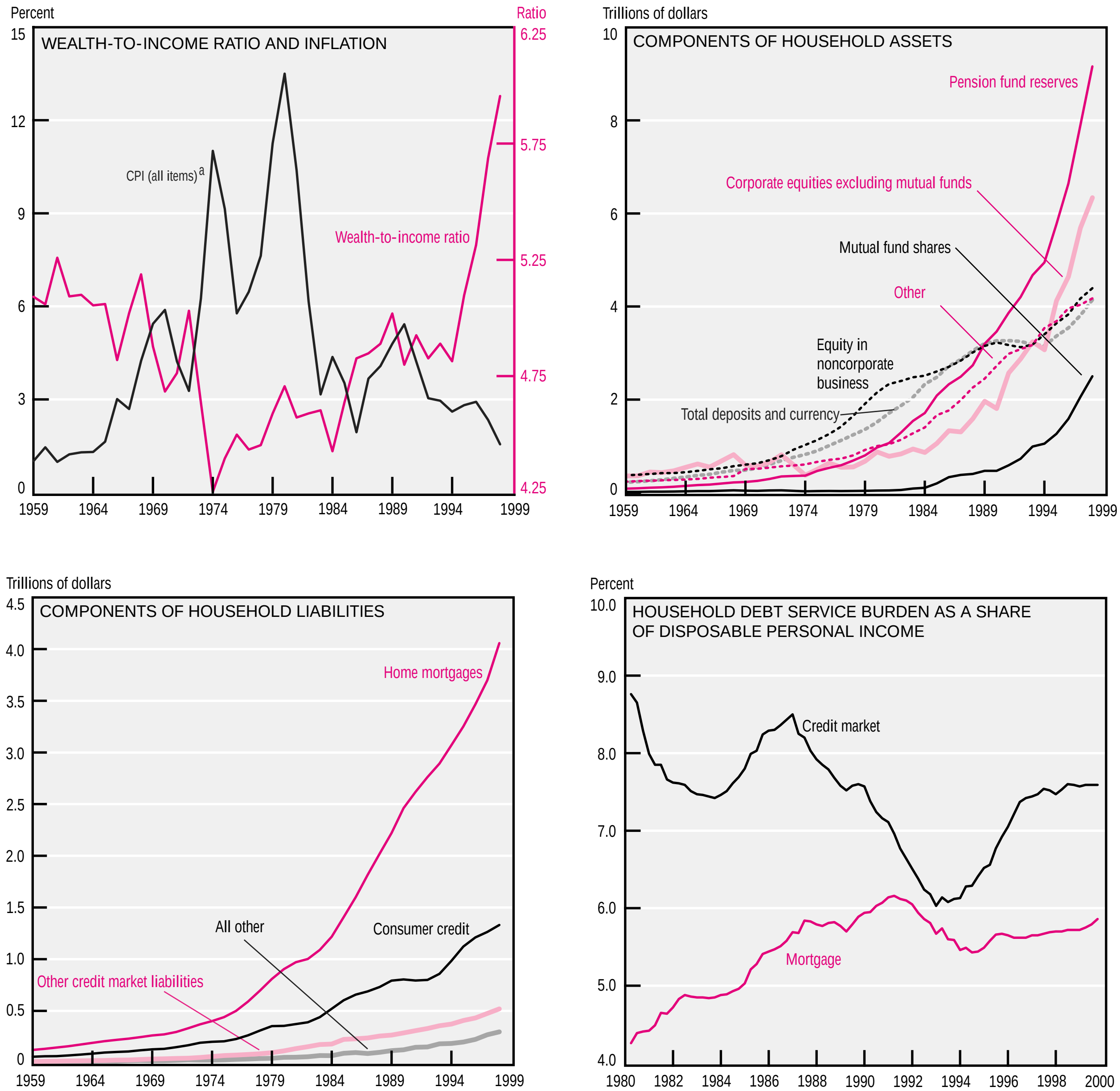

a. Year-over-year change.
NOTE: Wealth is defined as household net worth. Income is defined as personal disposable income. Data are not seasonally adjusted.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System.

growth has some value as an economic indicator, and will continue to monitor the monetary aggregates... ." M2 and M3 growth rates started out the year at or above the upper ranges, mirroring the experience of the past several years.

Finally, Chairman Greenspan expressed concern that the wealth effect associated with the rising stock market has contributed to a sharp rise in consumer spending that may soon place inflationary pressures on the economy. Households' wealth-to-income ratio has climbed to unprecedented levels, while the personal savings rate has declined dramatically. A comparison of inflation to the wealth-to-income ratio does not suggest an obvious relationship, but this may merely indicate that the relationship cannot be captured by such a simple graph.

Consider the constituent elements of the wealth-to-income ratio. Have the components of wealth that are tied to equity markets driven the increase in this ratio? Yes. Wealth, measured by a household's net worth, is simply an accounting identity, calculated as total assets minus total liabilities. Total assets have risen across the board, but the fastest-growing components—mutual fund shares, corporate equities, and pension reserves—are all tied to equity markets. While liabilities (most notably those reflected in home mortgages and consumer credit) are also rising substantially, their increase has not matched asset growth.