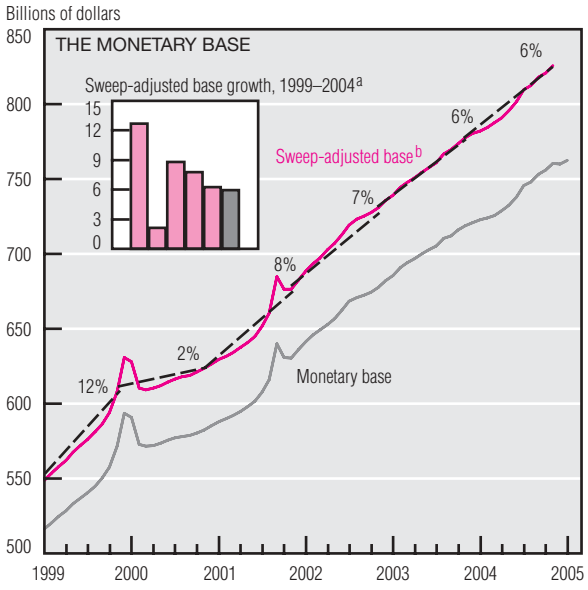
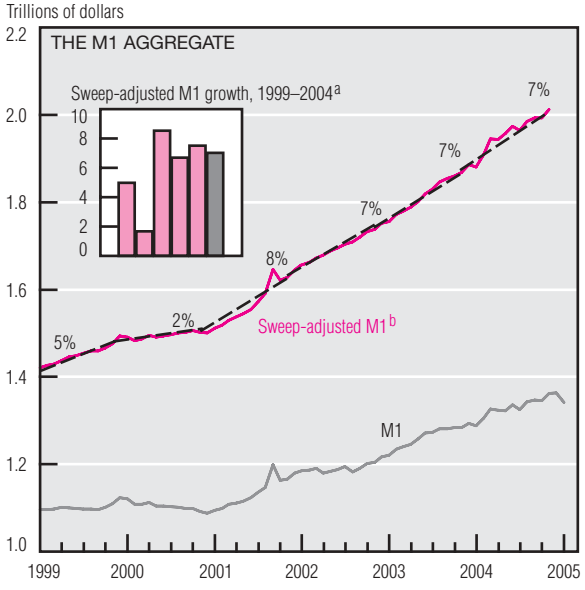
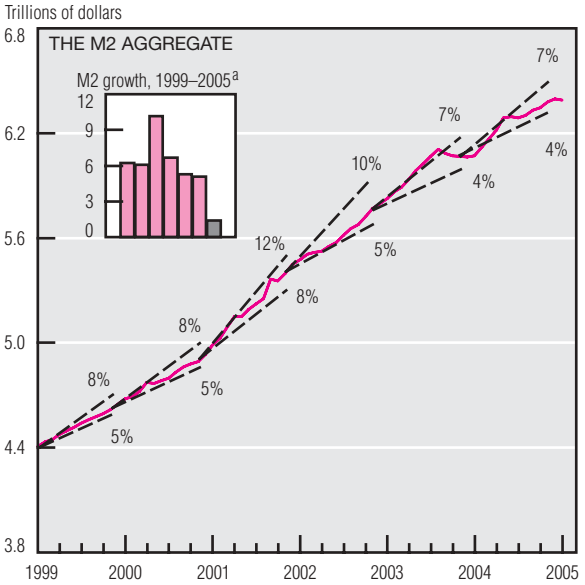
# Monetary Policy




**Growth Rates of Monetary Components (percent)**

| | Annual | | | | | | Average, 1999–2003 |
|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | |
| Monetary base[c] | 12.7 | 2.1 | 8.8 | 7.8 | 6.2 | 5.9 | 7.5 |
| M1[d] | 5.0 | 1.7 | 8.5 | 6.7 | 7.5 | 7.0 | 5.9 |
| M2 | 6.2 | 6.1 | 10.2 | 6.7 | 5.3 | 5.1 | 6.9 |
| Currency | 11.1 | 4.3 | 9.1 | 8.2 | 5.9 | 5.5 | 7.7 |
| Total reserves | –7.2 | –6.2 | 8.7 | –6.6 | 8.2 | 7.2 | –0.6 |
| Check and demande | –4.8 | –6.8 | 5.2 | –1.5 | 7.3 | 5.4 | –0.1 |
| Money market funds | 13.6 | 11.4 | 7.8 | –6.6 | –11.6 | –12.0 | 2.9 |
| Small time deposits | –0.7 | 9.6 | –5.0 | –9.1 | –9.3 | –0.4 | –2.9 |
| Savings deposits | 10.1 | 6.7 | 21.7 | 21.1 | 15.2 | 10.8 | 15.0 |

a. The far-right bars refer to the most recent data available. Growth rates are calculated on a fourth-quarter over fourth-quarter basis except for the far-right bar for M2, which refers to the annualized year-to-date growth rate from 2004:IVQ to January 2005. All data are seasonally adjusted.
b. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts.
c. Sweep-adjusted base.
d. Sweep-adjusted M1.
e. Demand deposits and other checkable deposits.
SOURCE: Board of Governors of the Federal Reserve System, "Money Stock Measures," *Federal Reserve Statistical Releases*, H.6.

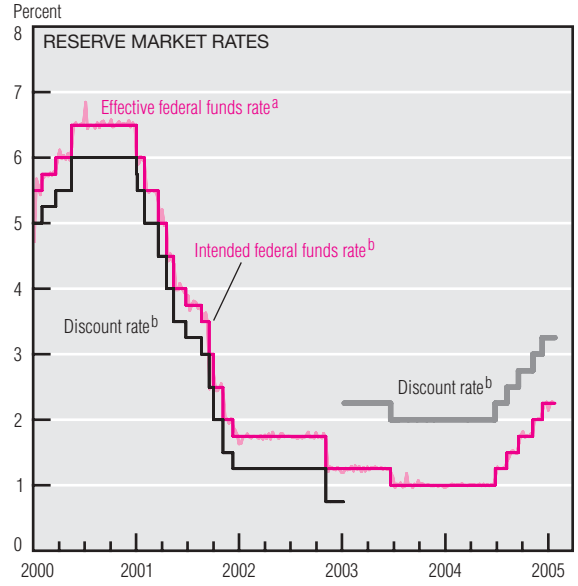
Growth in the sweep-adjusted monetary base (total currency in circulation plus total reserves plus vault cash of depository institutions not applied to reserve requirements) has been fairly constant for a couple of years. In 2004, however, it showed an annual growth rate of 5.9%, slower than its 7.5% average for 1999–2003. Base growth declined, primarily because currency growth slowed. Currency growth moderated to an annual rate of 5.5%, in contrast with its five-year average of 7.7%. On the other hand, total reserves rose 7.2% in 2004 after falling 0.6% over the previous five years.

M1, which consists of currency in the hands of the public plus demand and other checkable deposits, is a slightly broader monetary aggregate. Like the monetary base, sweep-adjusted M1 growth has been fairly stable for a couple of years. Unlike base growth, however, M1 growth was slightly higher than its 1999–2003 average. Much of this acceleration resulted from a sharp increase in the sum of demand deposits and other checkable deposits, which represent roughly 48% of M1. After falling 0.1% in 1999–2003, its growth rate rose 5.4% in 2004.

An even broader monetary aggregate, M2, grew 5.1% in 2004, 1.8 percentage points less than its 1999–2003 average. This slower growth resulted from a 12% decline in retail money market mutual funds and a slight (0.4%) decline in small time deposits in 2004. These declines partly offset the 7% advance in M1 and the 10.8% increase in savings deposits in 2004.

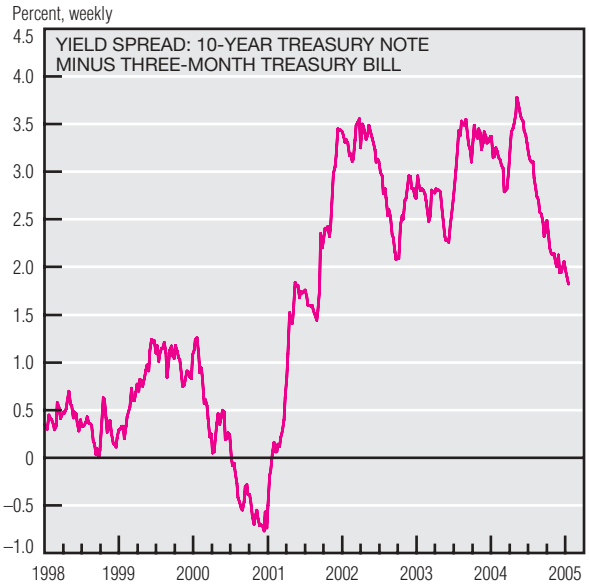
*(continued on next page)*

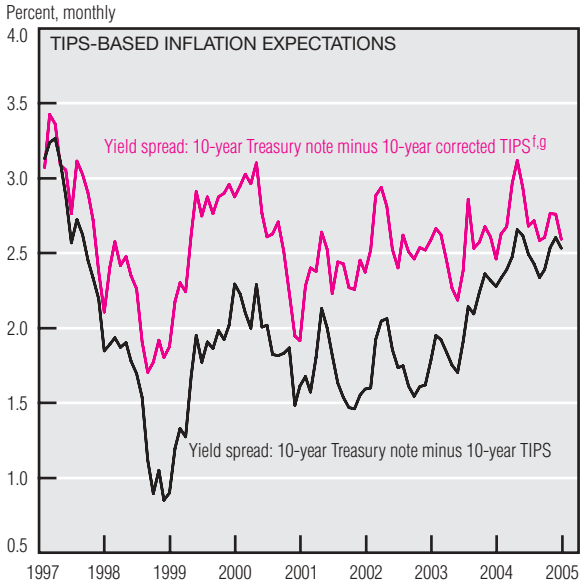
# Monetary Policy (cont.)




**Anticipated Target Federal Funds Rates (calculated January 27, 2004)**

| | | | | |
|---|---|---|---|---|
| | **February 1–2 meeting** | | | |
| Target federal funds rate | 2.25% | 2.50% | 2.75% | |
| Implied probability[c] | 0.0% | 98.5% | 1.5% | |
| | **March 22 meeting** | | | |
| Target federal funds rate | 2.25% | 2.50% | 2.75% | 3.00% |
| Implied probability[d] | 0.4% | 4.5% | 85.3% | 9.8% |
| | **May 3 meeting** | | | |
| Target federal funds rate | 2.50% | 2.75% | 3.00% | 3.25% |
| Implied probability[e] | 3.4% | 13.3% | 66.2% | 17.1% |




a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated using trading-day closing prices from options on February 2005 federal funds futures that trade on the Chicago Board of Trade.
d. Probabilities are calculated using trading-day closing prices from options on April 2005 federal funds futures that trade on the Chicago Board of Trade.
e. Probabilities are calculated using trading-day closing prices from options on May 2005 federal funds futures that trade on the Chicago Board of Trade.
f. The corrected TIPS yield is adjusted for the liquidity premium.
g. The liquidity premium is calculated as the difference between yields of on-the-run versus off-the-run conventional Treasuries, using data from the Board of Governors of the Federal Reserve System.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; and Bloomberg Financial Information Services.

At its meeting on December 14, 2004, the Federal Open Market Committee raised the target federal funds rate 25 basis points (bp) to 2.25%, the fifth such increase since the rate stood at 1% in June 2003. Evidence from options on federal funds futures implies that market participants expect a 25 bp rate increase at each of the next three meetings, which would raise the target federal funds rate to 3% after the May meeting.

The yield curve has flattened continuously over the past few months. The yield spread between the 10-year Treasury note and the three-month Treasury bill dropped from 343 bp in June to 182 bp in late January. Although an inversion of the yield curve frequently portends a recession, as it did in 2001, a flattening of the yield curve is not necessarily bad news for the economy. Flattening can result from changes in economic fundamentals, inflation expectations, or both. The yield curve can be expected to flatten with increases in short-term interest rates if long-term inflation expectations remain well anchored. If we use Treasury inflation-protected securities (TIPS) to gauge inflation expectations over the next 10 years, we see that both the raw TIPS numbers and those adjusted for liquidity risk are hovering around 2.6%. The five recent hikes of 25 bp each in the target rate, coupled with the market's expectation of gradual, continued tightening, seem to have reinforced the public's confidence that the Federal Reserve will not let inflation accelerate.