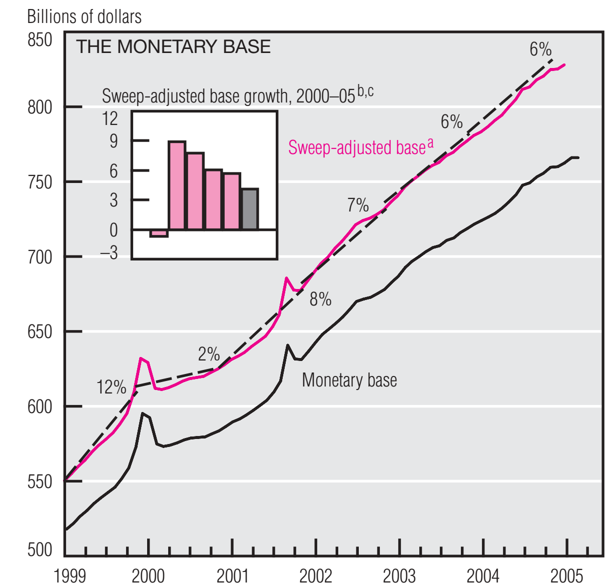
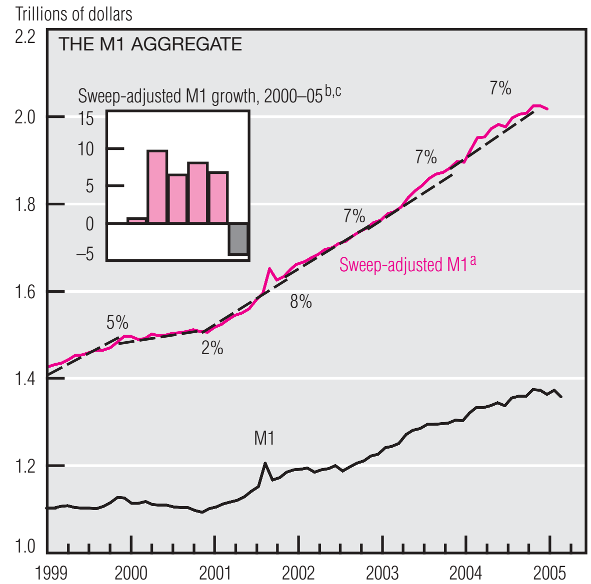
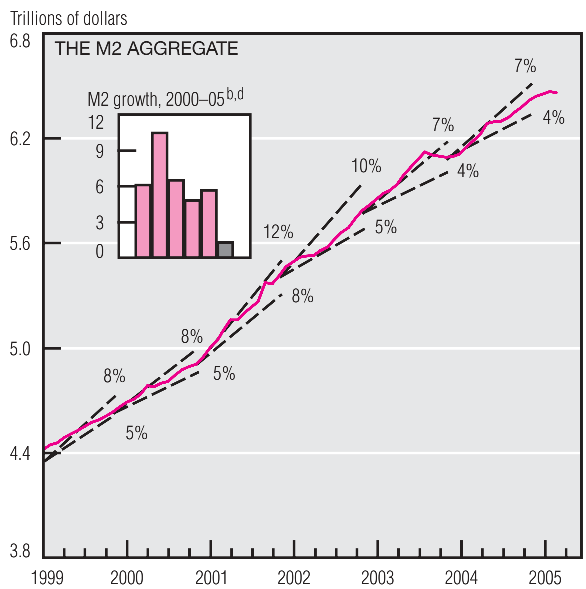
Monetary Policy







Growth Rates of Monetary Components (percent)

	Annual						Average,
	2000[e]	2001[e]	2002[e]	2003[e]	2004[e]	YTD 2005	2000–2004
Monetary base	–0.7	8.9	7.7	6.1	5.7	4.1[c]	5.5
M1[a]	0.6	9.6	6.4	8.0	6.7	–4.2[c]	6.3
M2	6.1	10.5	6.5	4.8	5.7	1.3[d]	6.7
Currency	2.7	9.4	7.7	5.7	5.3	3.0[d]	6.2
Total reserves	–7.8	7.1	–2.3	5.9	8.9	–9.8[d]	2.4
Check and demand[f]	–8.1	7.6	–1.2	8.0	5.3	–12.4[d]	2.3
Money market funds	11.0	6.6	–7.2	–12.4	–10.6	–8.3[d]	–2.5
Small time deposits	9.4	–6.9	–8.3	–9.3	0.8	14.4[d]	–2.9
Savings deposits	7.9	23.2	20.2	14.1	11.2	2.4[d]	15.3

NOTE: All data are seasonally adjusted.
a. The sweep-adjusted base contains an estimate of required reserves saved when balances are temporarily shifted from reservable to nonreservable accounts. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts.
b. The far-right bar refers to the most recent data available.
c. Year-to-date growth rates are calculated on a January 2005 over December 2004 basis.
d. Year-to-date growth rates are calculated on a March 2005 over December 2004 basis.
e. Annual growth rates are calculated on a December over December basis.
f. Demand deposits and other checkable deposits.
SOURCES: 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) moderated in January. Its annualized January growth rate of 4.1% is below the five-year average of 5.5%. Base growth declined because currency growth slowed to 4.8% in January. Through March 2005, currency growth decelerated to an annualized rate of 3.0%, roughly 3.2 percentage points below the five-year average. The amount of total reserves (not seasonally adjusted) has fallen at a substantial 9.8% annualized rate so far this year after rising 8.9% in 2004.

M1, which consists of currency in the hands of the public plus demand and other checkable deposits, is a slightly broader monetary aggregate. In January, sweep-adjusted M1 declined at an annualized rate of 4.8%, largely because a sharp decrease in demand and other checkable deposits more than offset the 3% annualized year-to-date growth in currency.

An even broader monetary aggregate, M2, has grown 1.3% through March, 5.4 percentage points below the five-year average. This slower growth resulted primarily from the continued decline in retail money market mutual funds (8.3%) and the decline in M1 (4.5%). These declines partly offset the 2.4% year-to-date advance in savings deposits.

At its March 22 meeting, the Federal Open Market Committee (FOMC) raised its target for the federal funds

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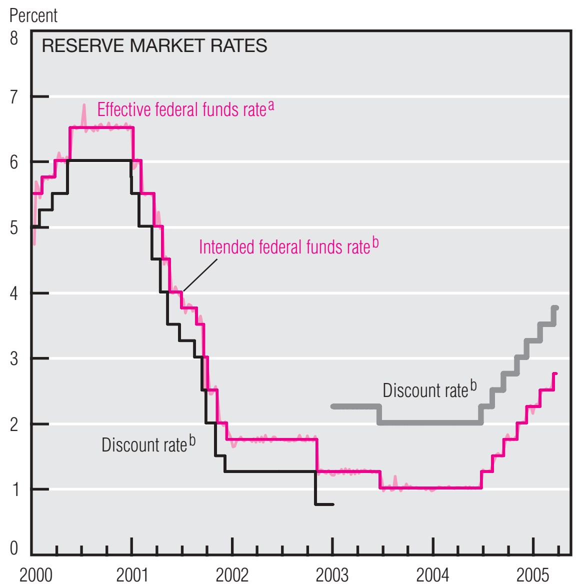
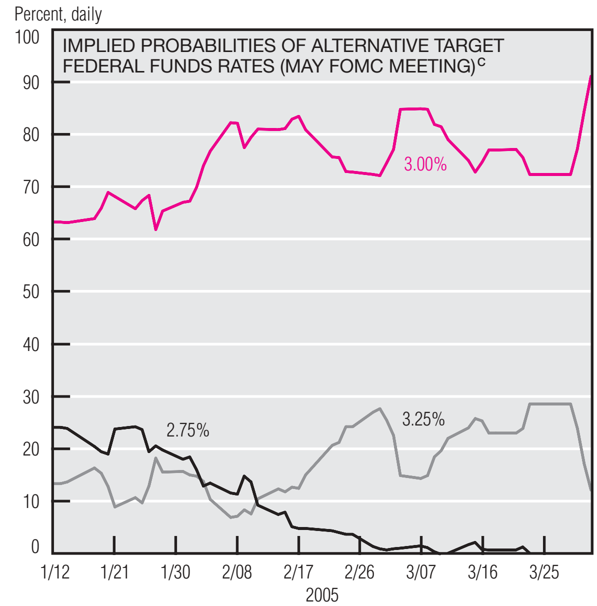
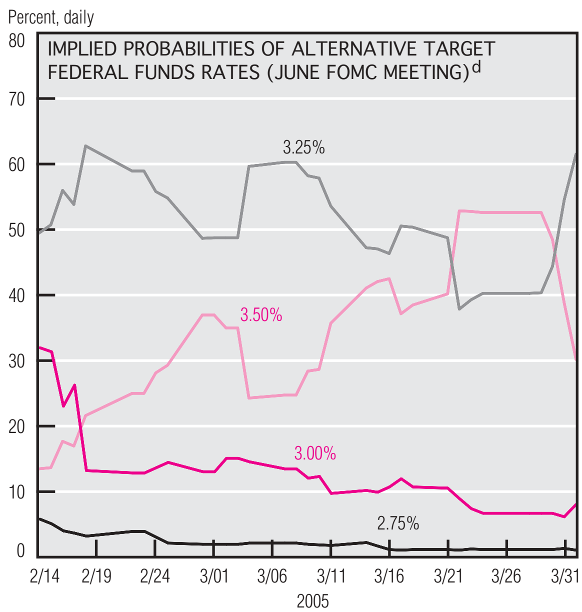
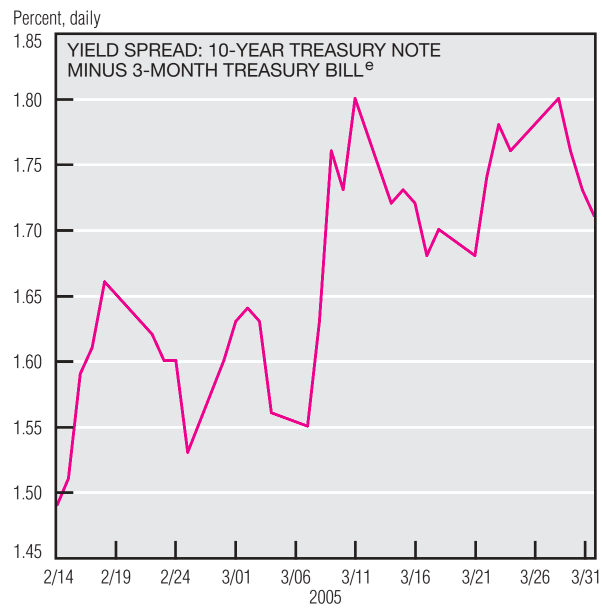
Monetary Policy *(cont.)*









a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated using trading-day closing prices from options on May 2005 federal funds futures that trade on the Chicago Board of Trade.
d. Probabilities are calculated using trading-day closing prices from options on July 2005 federal funds futures that trade on the Chicago Board of Trade.
e. All yields are from constant-maturity series.
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.

rate by 25 basis points (bp) to 2.75%, the seventh such increase since the current round of tightening began in late June 2004. (Separately, the Federal Reserve's Board of Governors approved Reserve Bank requests to raise the discount rate to 3.75%.) The FOMC's press release stated that "even after this action, the stance of monetary policy remains accommodative." Market participants anticipate that the federal funds rate will continue to rise; however, the timing and magnitude of the increases are uncertain. Evidence from options on fed funds futures implies that, at close of business on April 1, traders saw a 91% probability that the rate will be raised to 3.00% at the May 3 meeting.

The March meeting brought a change in the language of the FOMC's statement, which noted that "pressures on inflation have picked up in recent months and pricing power is more evident." This change seemed to affect market expectations of the future course of monetary policy, especially for the June 30 meeting. Immediately after the March meeting, the probability that the funds rate will be 3.5% by July jumped from 40% to 53%, exceeding the probability of a 3.25% funds rate. However, lower-than-expected core inflation for personal consumption expenditures on March 31 and a worse-than-expected employment report on April 1 more than wiped out these hikes; the probability of a 3.5% funds rate in July fell back to 30%. Yield spreads between the 10-year Treasury note and the three-month Treasury bill also narrowed in response to these reports, perhaps reflecting a drop in long-term inflation expectations as well.