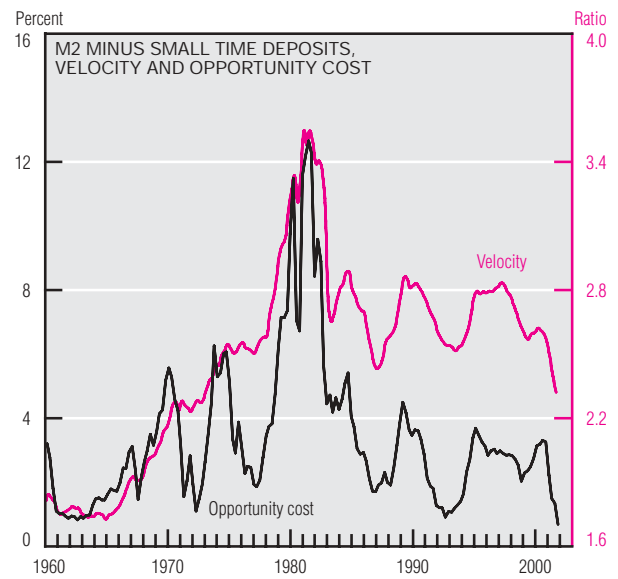
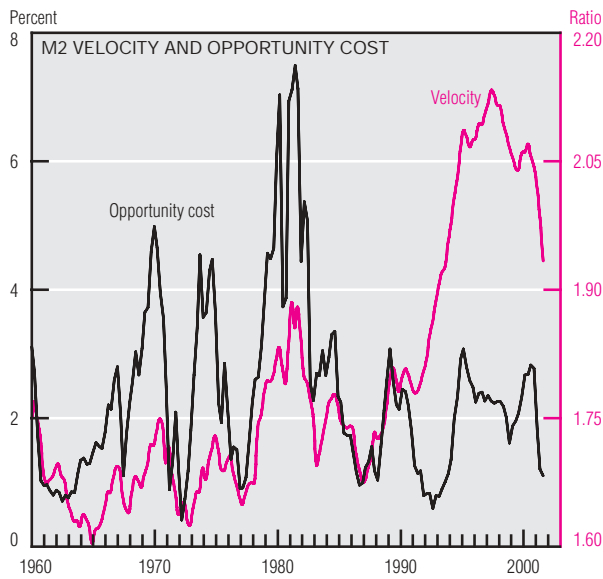
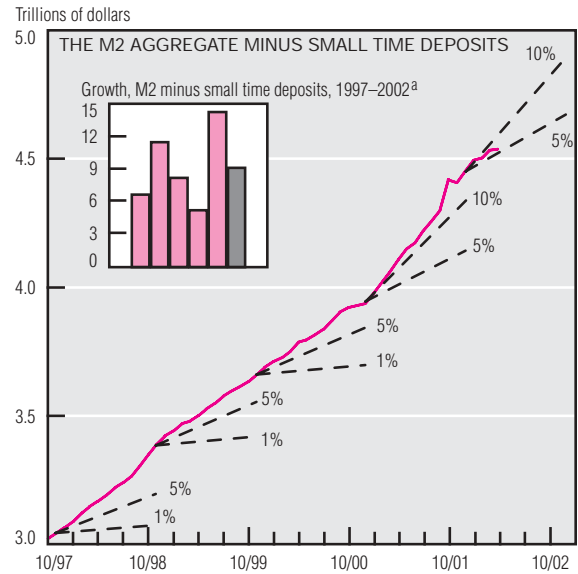
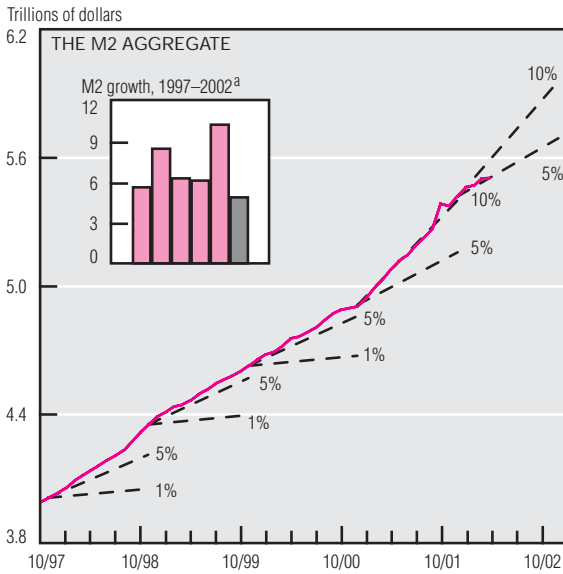


Monetary Policy



a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.
SOURCE: Board of Governors of the Federal Reserve System.

In simple textbook models of the aggregate economy, monetary policy is either expansionary, contractionary, or neutral with respect to the real economy and the price level, depending on the pace at which the money supply expands relative to demand. Making use of this framework, however, requires that supply and demand for money have a stable relationship with economic activity and prices. Unfortunately, experience demonstrates that these relationships lack the stability needed to transform

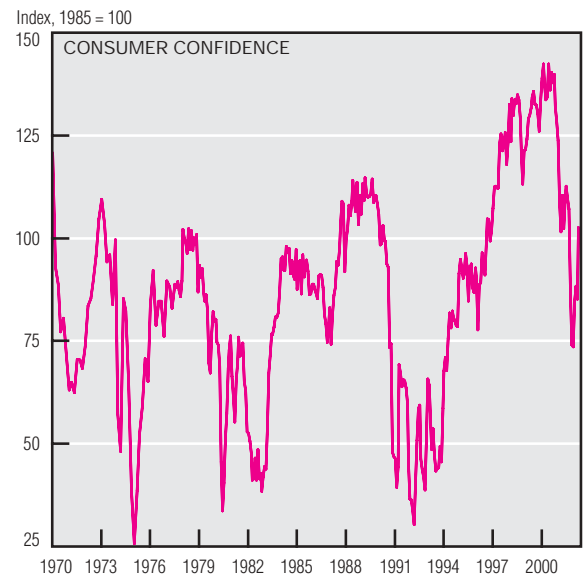
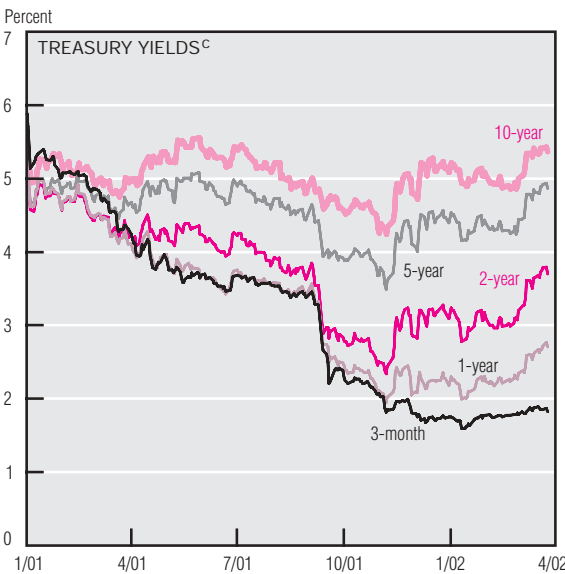
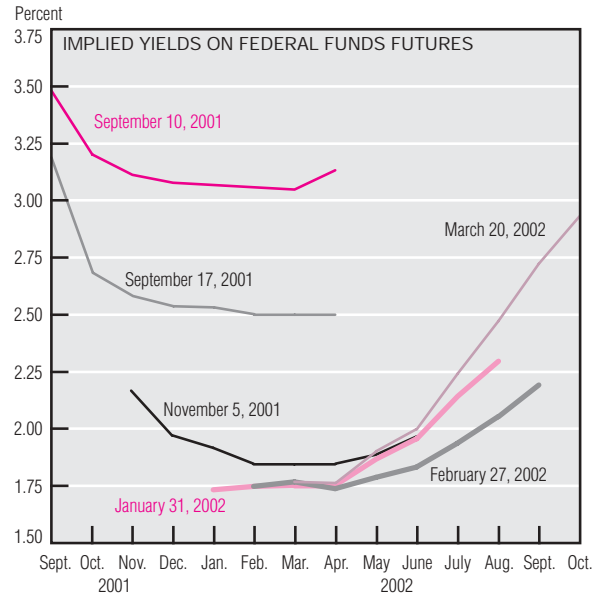
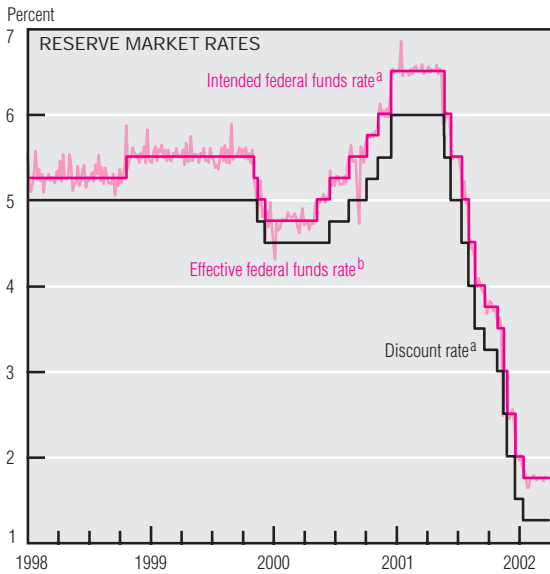
the textbook model into a dependable, real-time policy tool.

In the early 1990s, for example, the M2 measure of money became less reliable as a guidepost for policy. Its relationship to economic activity as summarized by its velocity—the ratio of GDP to M2—changed unexpectedly. M2 velocity increased dramatically relative to its opportunity cost. Thus, the increase in M2 growth during that period was not associated with an increase in inflation, as history would have suggested.

Another measure of money, M2 minus small time deposits, was unaffected by the events of the early 1990s. Although its growth has been strong in recent years, its velocity has fallen dramatically with declines in its opportunity cost. If interest rates rise, as the federal funds futures suggest, we would expect to see sharp declines in the growth of M2 minus small time deposits, along with increases in its velocity and thus prices. Its failure to slow down would be cause for concern.

(continued on next page)

Monetary Policy (cont.)



- a. Daily.
- b. Weekly average of daily figures.
- c. Constant maturity.

SOURCES: Board of Governors of the Federal Reserve System; Chicago Board of Trade; Conference Board; and Bloomberg Financial Information Services.

At its March 19 meeting, the Federal Open Market Committee left the intended federal funds rate unchanged at 1.75%. However, the FOMC adopted a neutral stance, namely, that the risks are balanced between heightened inflation pressures and economic weakness. This was the first time since November 15, 2000 that the risk statement was not skewed toward economic weakness.

In the weeks leading up to and shortly after the recent FOMC meeting, implied yields on federal funds

rose substantially, particularly for futures delivering in August and later. Market participants are currently pricing in a rise of nearly 125 basis points in the effective federal funds rate by October. This increase in federal funds futures was accompanied by rate increases for Treasury securities longer than one year. The behavior of short-term rates (one year or less) primarily reflects the anticipated increase in the funds rate over the coming year.

Speculating on why long-term rates increase is a tricky business.

Given the recent stronger-than-expected economic data, at least part of the story very likely is that the expected return on investment has gone up. Consumer confidence (as measured by the Conference Board), which often surges near the end of or shortly after recessions, rose a hefty 15 points in March. Furthermore, the present situation and expectations components of the index each went up 15 points, suggesting that appraisals of both current and future economic conditions have improved.