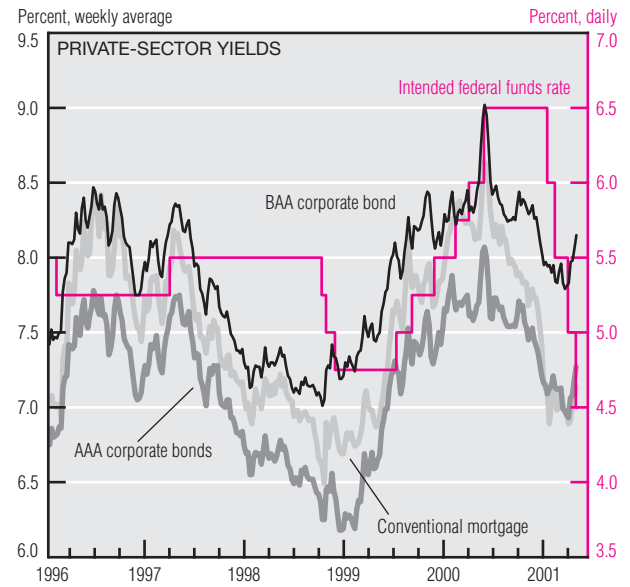
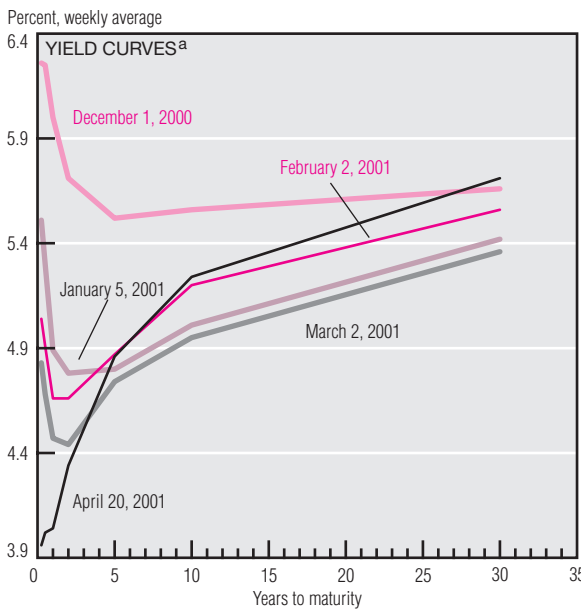
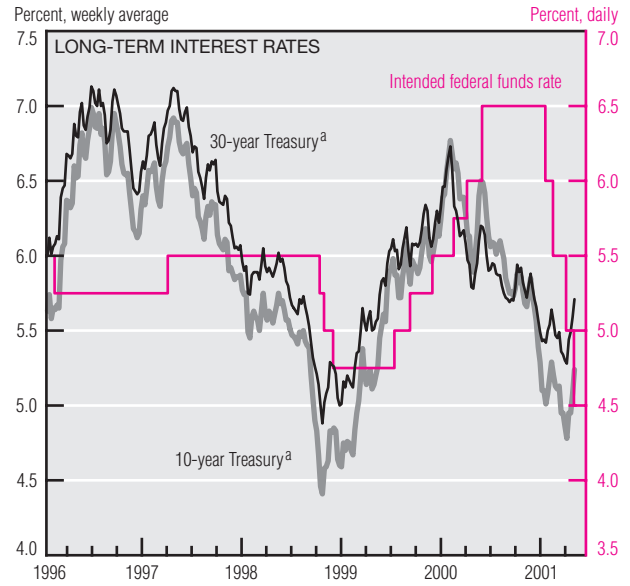
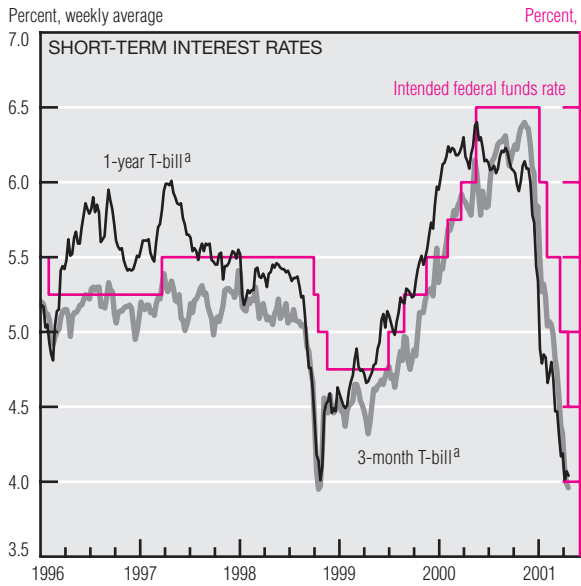


# Money and Financial Markets



a. Constant maturity.  
SOURCE: Board of Governors of the Federal Reserve System.

Starting in mid-1999, the intended federal funds rate first was raised from 4.75% to 6.5% in six steps and then was cut sharply to 4.5% in four moves of 50 basis points (bp) each. When the FOMC changes the intended fed funds rate—the rate at which banks can borrow reserve balances from each other overnight—it is often said simply to be “lowering interest rates.” In fact, the entire array of other interest rates is determined by participants (lenders and borrowers) in a wide variety of financial markets, and individual rates can move with or opposite to the target

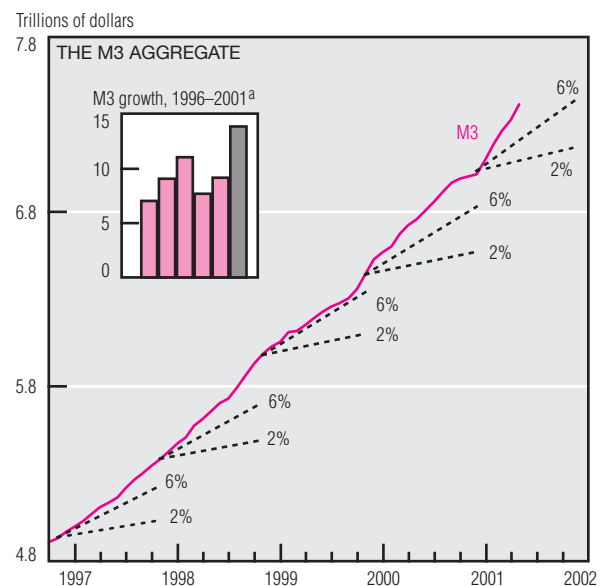
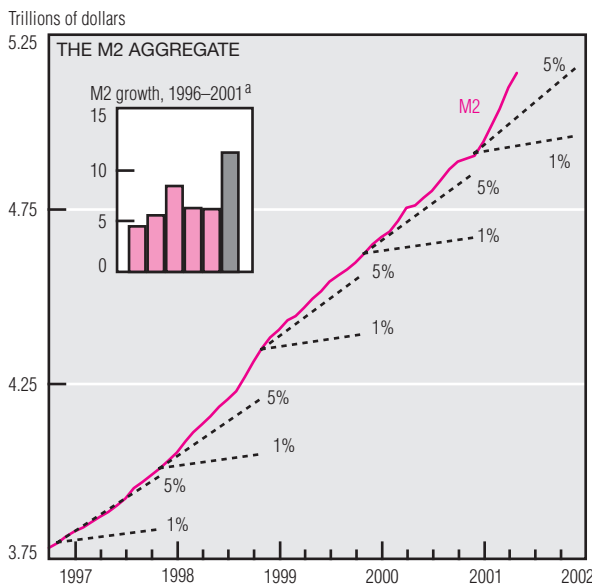
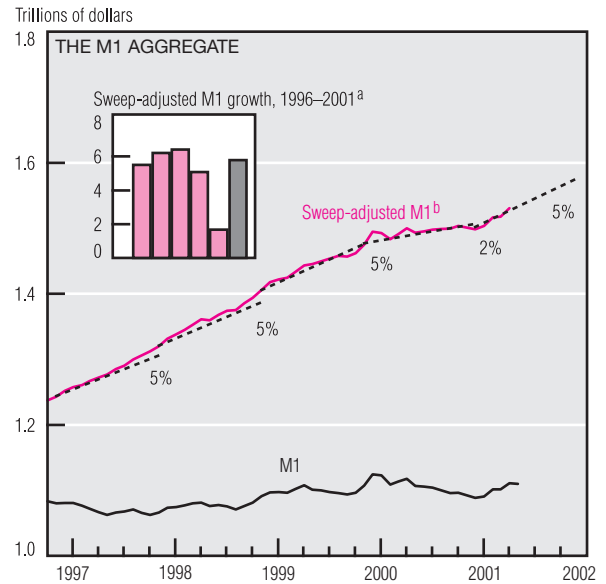
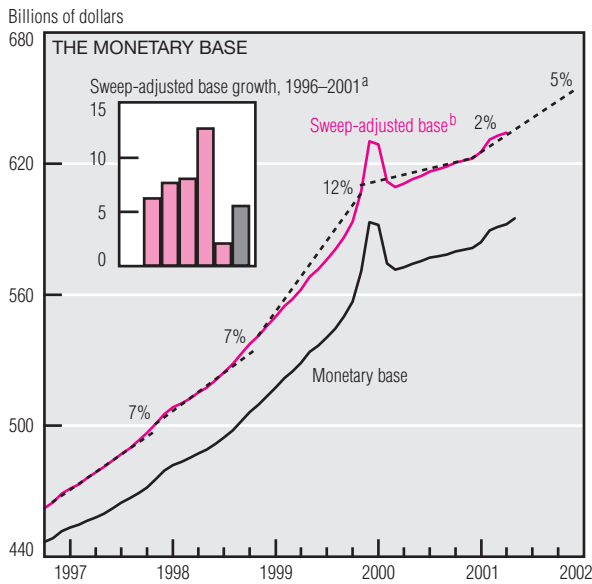
rate. It is true that the intended funds rate and market interest rates, especially short-term rates, tend to follow the same general pattern. However, it is not uncommon to see some market rates moving in the opposite direction from the policy rate, even over fairly long periods.

The 200 bp decline in the intended funds rate, which began on January 3, 2000, has been accompanied by a similar decline in 3-month and 1-year T-bill yields, which have fallen 188 bp and 171 bp to 3.96% and 4.02%, respectively, since the end of last year. However, this

pattern does not hold for long-term interest rates. Since year's end, yields on the 10-year and 30-year Treasury have risen 14 bp and 27 bp to 5.24% and 5.71%, respectively. The decline in short-term rates has completely eliminated the yield curve's inversion for the first time since January 2000; we now have a traditional, upward-sloping yield curve. An inverted yield curve is often seen as a predictor of an economic slowdown or recession, presumably making yield curves with the current shape harbingers of future growth.

(continued on next page)

## Money and Financial Markets (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2001 growth rates for the sweep-adjusted base and sweep-adjusted M1 are calculated on a March over 2000:IVQ basis. The 2001 growth rates for M2 and M3 are calculated on an estimated April over 2000:IVQ basis. 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.

NOTE: Last plots for the monetary base, M1, M2, and M3 are estimated for April 2001. Last plots for the sweep-adjusted base and sweep-adjusted M1 are March 2001. Prior to November 2000, dotted lines for M2 and M3 are FOMC-determined provisional ranges. All other dotted lines represent growth rates and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

Yields on AAA and the slightly lower-quality BAA corporate bonds also have risen somewhat over the course of the year, while conventional 30-year mortgage rates have been virtually unchanged.

At first blush, money growth appears to be expanding rapidly across the spectrum of monetary aggregates. On closer inspection, however, a plausible case can be made that the narrow aggregates are not too far out of line with recent history after Y2K effects are

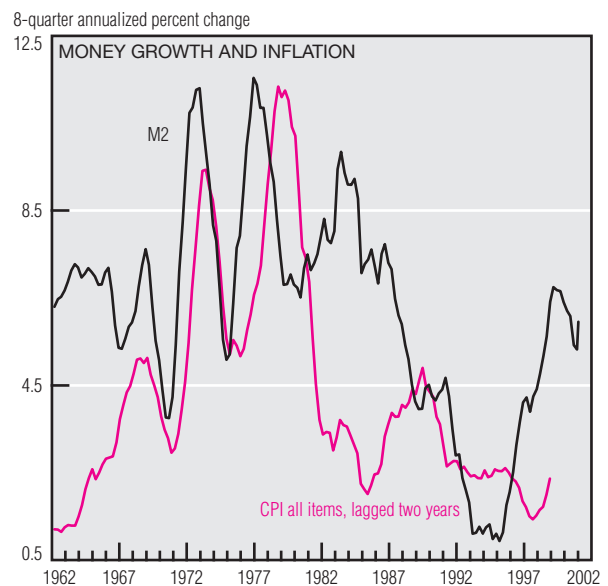
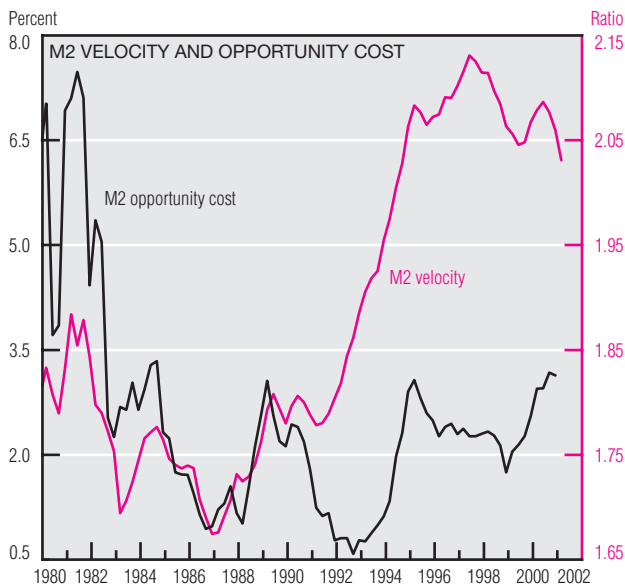
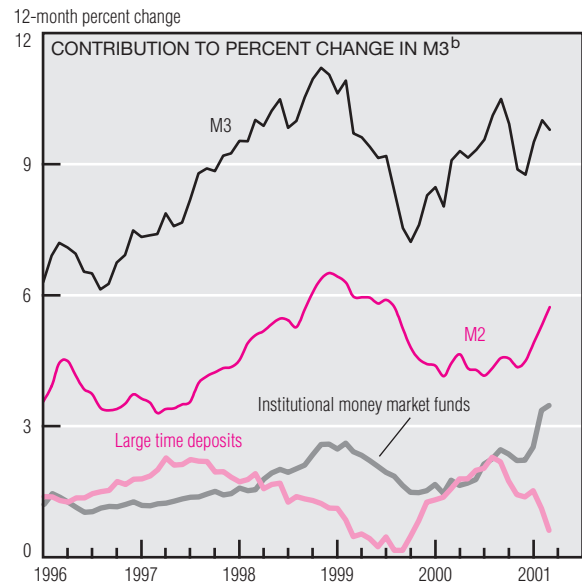
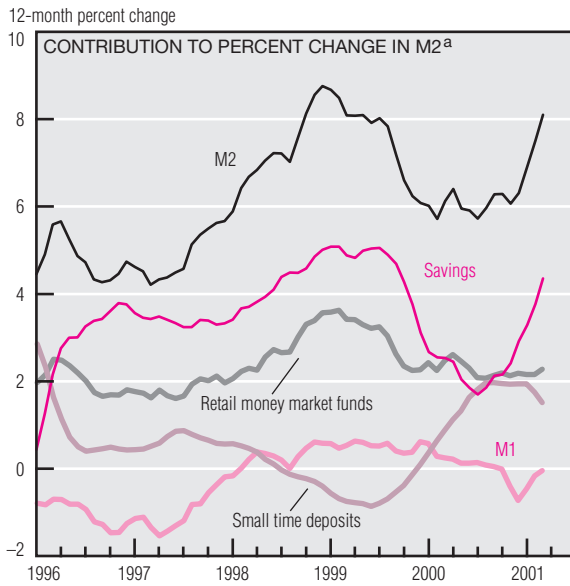
accounted for, while much of the growth in the broad aggregates can be attributed to a few sources.

Year-to-date growth of the sweep-adjusted monetary base reached 5.5% and sweep-adjusted M1 hit 5.8% at annual rates through March (the most recent sweeps data available). Compared to last year's annual growth, these rates appear very rapid indeed, but a longer view eliminates Y2K-related volatility and reveals that rates are consistent with the growth experienced during the latter half of the current expansion.

Although the broad monetary aggregates were largely insulated from Y2K-related fluctuations, they currently depict growth that is well above recent annual rates. Estimated year-to-date annual growth rates for April are 11.8% for M2 and 13.9% for M3. Keep in mind that uncertainty surrounding tax receipts and payments makes definitive interpretation of the broad aggregates difficult at this time of year. Transitory factors such as increased mortgage refinancing and stock market volatility can lead to temporary increases as

(continued on next page)

## Money and Financial Markets (cont.)



a. Weighted by share of M2.

b. Weighted by share of M3. Overnight and term repurchases and overnight and term eurodollars not shown.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

funds are “parked” in savings and money market mutual funds. Examining individual components’ contributions to the growth rates of the broader aggregates supports this interpretation. The recent surge in M2 growth is due almost entirely to growth in savings deposits (1.4 of the 1.8 percentage point increase in year-over-year M2 growth between December 2000 and March 2001). In turn, M2 growth contributed 1.2 percentage points—and institutional money market mutual funds

1.3 percentage points—to the 1.0 percentage point increase in M3 growth, offsetting total declines of 1.5 percentage points concentrated in large time deposits.

The monetary aggregates have featured less prominently in monetary policy since the widely recognized breakdown in many money-demand models during the early 1990s. An enduring shift in velocity (the ratio of economic activity to money) during this time made it hard to determine the quantity of money demanded.

Thus, it was difficult to know whether observed money-supply growth exceeded the unpredictable noninflationary money-demand growth. Over long periods, however, inflation undoubtedly is related to money growth. Given the substantial lags associated with monetary policy, the 200 bp cut in the intended federal funds rate might result in continued rapid money growth, which could cause inflationary pressures.