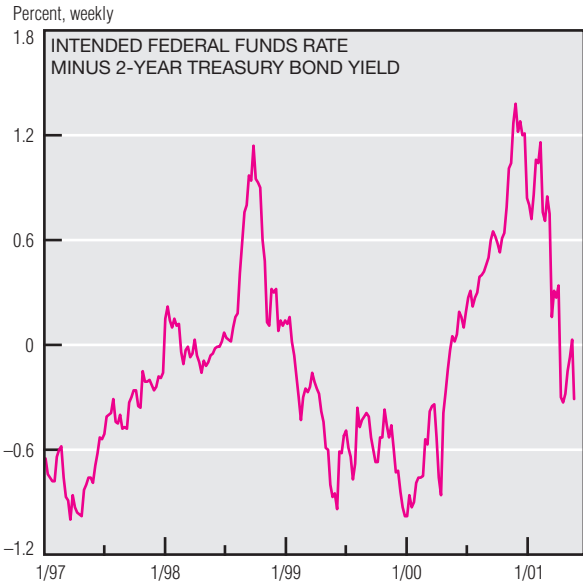
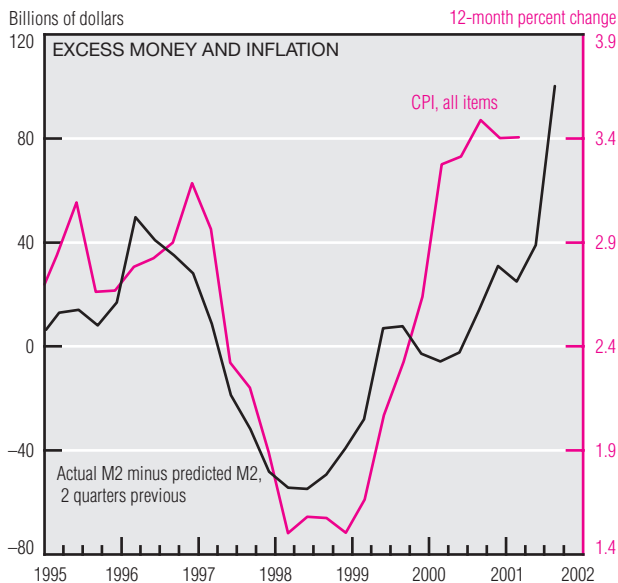
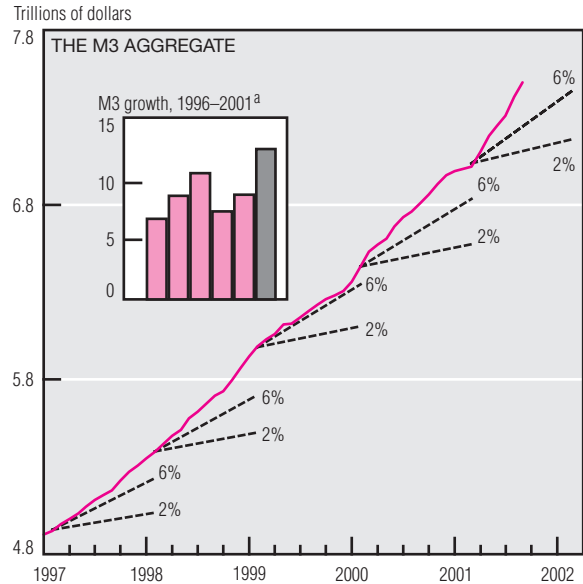
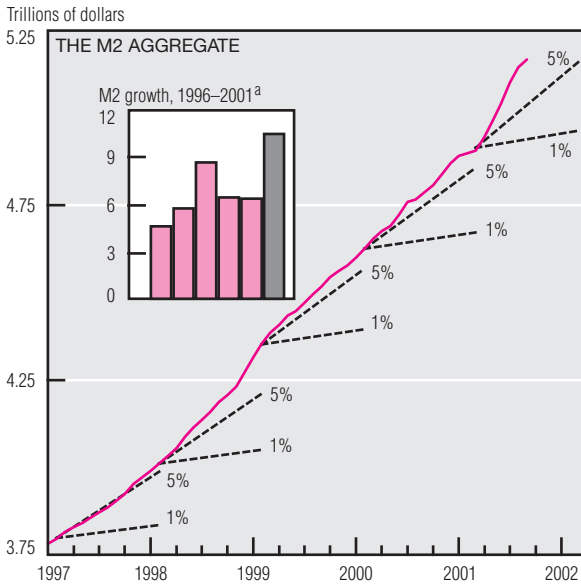


Money and Financial Markets



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2001 growth rates for M2 and M3 are calculated on a May over 2000:IVQ basis. Data are seasonally adjusted.

NOTE: Last plots for M2 and M3 are May 2001. Prior to November 2000, dotted lines for M2 and M3 are FOMC-determined provisional ranges. Subsequent dotted lines represent growth rates and are for reference only.

SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of Cleveland; and Bloomberg Financial Information Services.

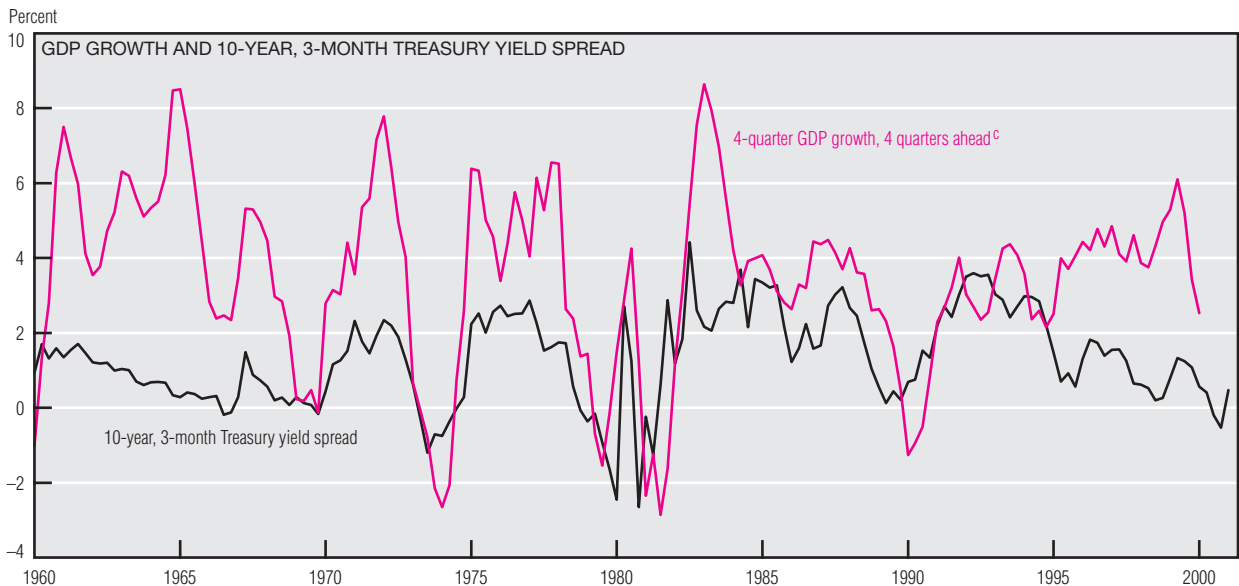
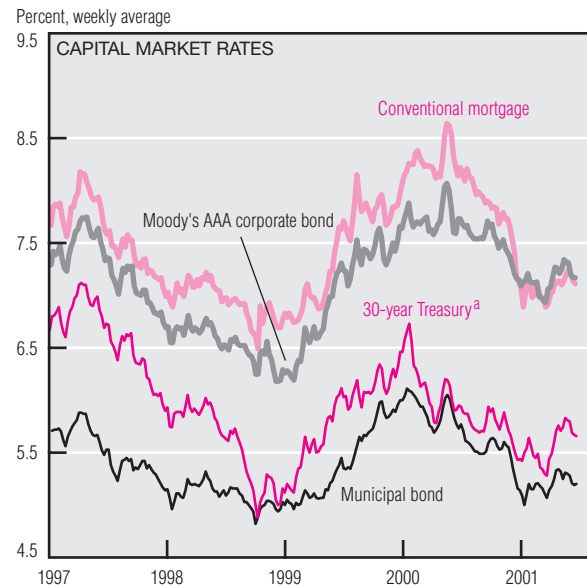
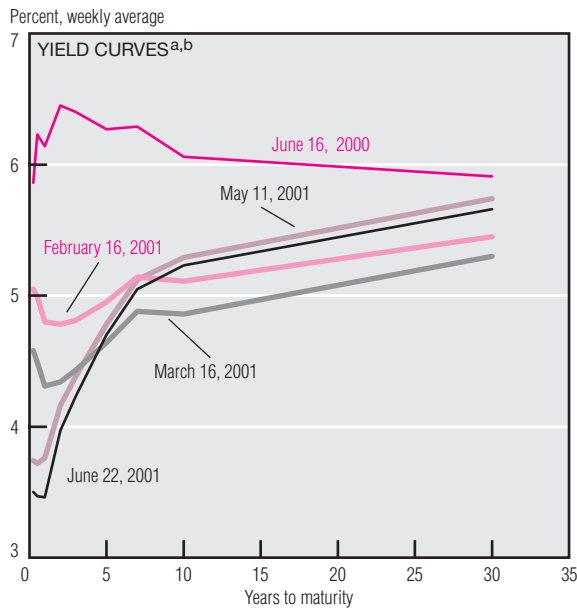
Have we gone too far? Or is this just a beginning? Some consider the actions of the Federal Open Market Committee (FOMC) during the current economic slowdown fully consistent with the quest for maximum long-term real growth through low inflation. Others question whether the possibility of recession has become the focus of undue attention so that the FOMC is ignoring potential consequences for more rapid inflation.

From the perspective of the broad monetary aggregates, annualized growth of M2 and M3 so far in 2001 has outpaced that of the past five years. What may be more informative is excess money, defined as actual money minus predicted money demand. Historically, excess M2 (lagged two quarters) follows a pattern similar to that of consumer price inflation. Excess M2 has escalated sharply based on GDP for 2001:1Q and the most recent M2 levels.

The spread between market rates (here, two-year Treasuries) and the FOMC-controlled federal funds rate provides a different perspective. This spread has fallen sharply since the beginning of the year, mostly because the FOMC made five consecutive cuts of 50 basis points (bp) each in the intended federal funds rate. The additional 25 bp cut on June 27 reversed a recent uptick, so the spread remains near its five-year

(continued on next page)

Money and Financial Markets (cont.)



a. All yields are from constant-maturity series.

b. Average for the week ending on the date specified.

c. Real GDP growth.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

average, perhaps suggesting that policy has not gone too far.

The yield curve has not changed appreciably in the past month. Last June's inversion has disappeared almost totally. The shortest maturities, closely tracking FOMC rate cuts, are down to about 3.6%. Longer maturities have not declined as much and have backed up about 40 bp since mid-March. The overall steep positive slope at the short end seems consistent with future economic

growth. Other long-term rates—on mortgages and on municipal and corporate bonds—have followed the same pattern as the benchmark 30-year Treasury bond, falling until April and rising somewhat since then.

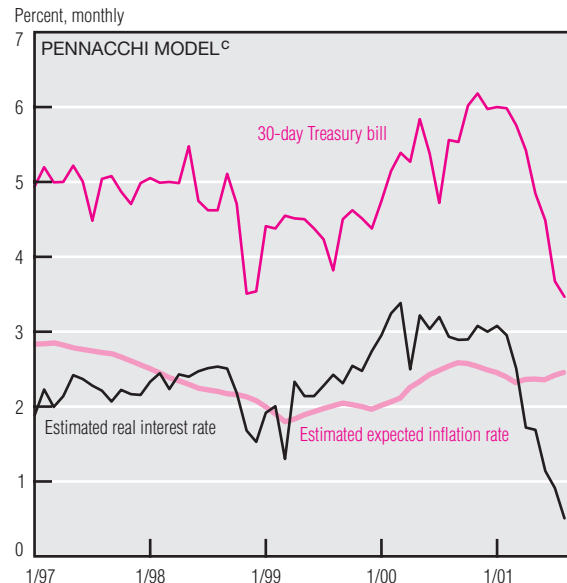
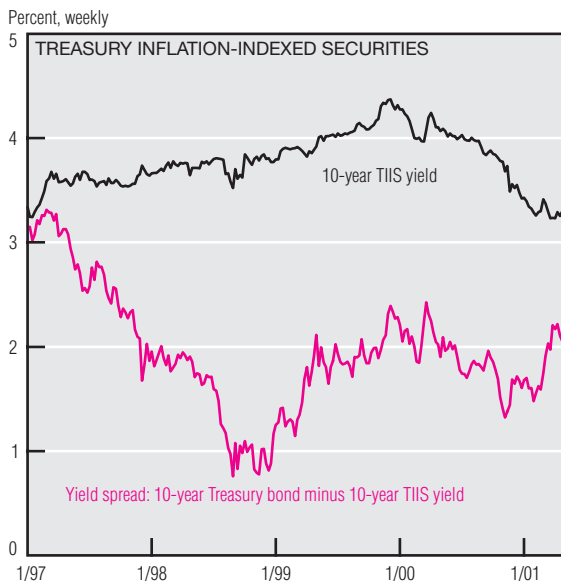
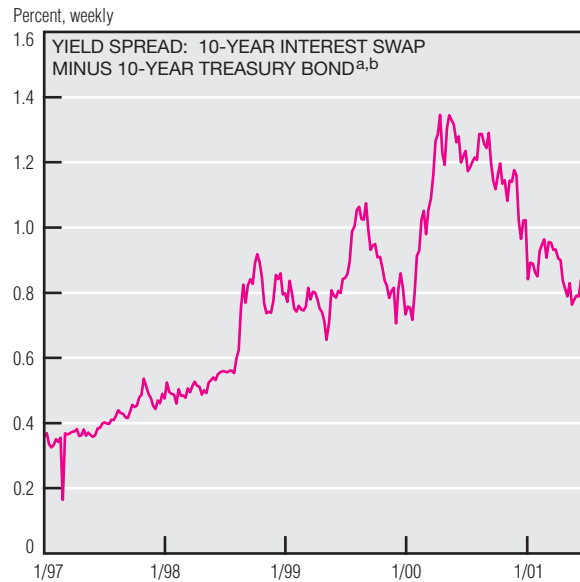
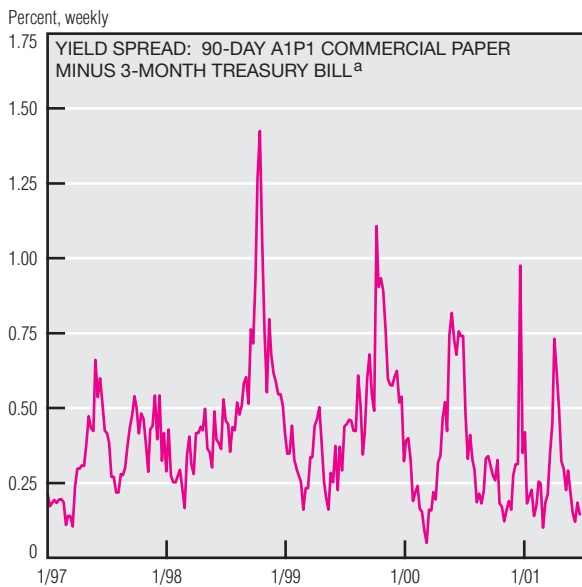
The spread between 10-year and 3-month Treasuries, which contains much the same information as the yield curve, historically has been correlated with the level and direction of real GDP growth four quarters ahead. Although in certain periods

this relationship has not been clear, the recent uptick in the spread might be interpreted as a good sign of future growth.

The spread between yields at different maturities may signal investors' expectations of yields in different time periods of the future. In addition to these so-called term spreads, risk spreads compare yields on a security to that on a safe benchmark, usually a Treasury security. Both short- and long-term risk spreads have declined

(continued on next page)

Money and Financial Markets (cont.)



a. Bloomberg generic series.

b. Quote for semiannually fixed rate versus the U.S. dollar's 3-month London interbank offered rate (LIBOR).

c. The estimated expected inflation rate and the estimated real rate are calculated using the Pennacchi model of inflation estimation and the median forecast for the GDP implicit price deflator from the *Survey of Professional Forecasters*. Monthly data.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*; and Bloomberg Financial Information Services.

recently. However, the longer-term spread is still at the level it reached just after the Russian default and the Long Term Capital Management crisis. The spread between 90-day A1/P1 commercial paper and the 3-month Treasury yield, however, is quite low—only a bit above the levels of spring 2000.

Treasury inflation-indexed securities (TIIS), first issued in 1997, offer a yield indexed to the Consumer Price Index. Initially, public interest

in TIIS was slight, perhaps because inflation was quite low. Then, as TIIS's inflation protection became more widely appreciated, they were incorporated into more portfolios. The spread between yields on non-indexed Treasuries and on TIIS is a potential measure of investors' inflation expectations. This spread started rising in February but more recently receded a bit. Pennacchi model estimates indicate only very slowly rising inflation expectations over the

past year and steeply declining real short-term rates.

Rapid growth of the monetary aggregates and recent increases in the Consumer Price Index suggest a potential risk of rising inflation. However, the behavior of the intended federal funds rate and various other market rates seem consistent with the FOMC's most recent policy statement, suggesting that easing pressures in producer and labor markets will keep inflation contained.