Monetary Policy

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May 1996
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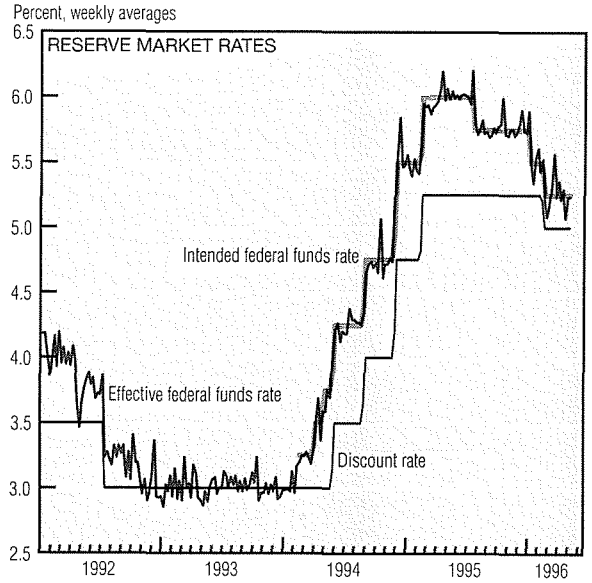

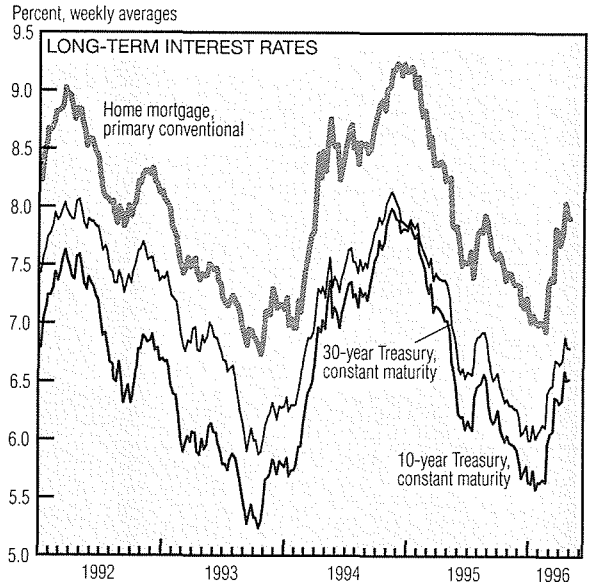

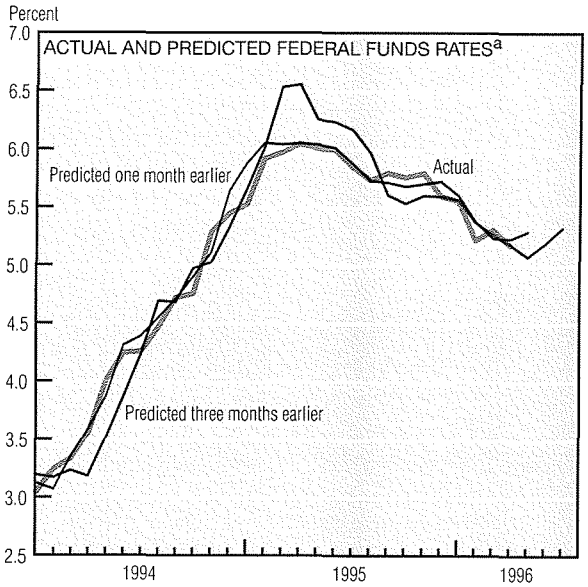

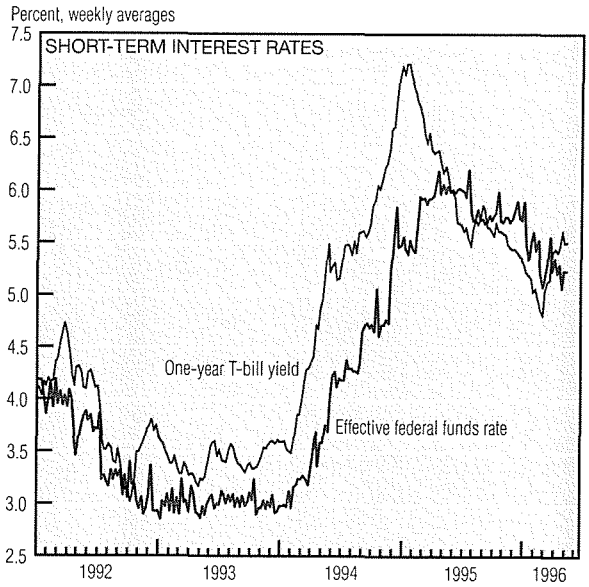

a. Predicted rates are federal funds futures.
SOURCES: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

Since the Federal Open Market Committee's last meeting on March 26, interest rates have drifted up across all maturities. The initial turnaround in long-term rates occurred just before the February 1 reduction in the intended federal funds rate.

A harsh winter helped to push up energy prices and raised concerns about inflation. Subsequent employment reports have revealed a stronger-than-expected economy, despite the severe weather and the strike at General Motors. Measurable gains in retail sales and industrial production have corroborated the economy's underlying vitality.

Strong economic activity is usually connected with higher rates of return on new business investment and, in turn, with a higher level of interest rates in general. Long-term rates have jumped substantially, with conventional mortgage rates surging about 100 basis points above their recent trough in February.

Concerns about inflation and growing evidence of economic strength have been associated with a change in market expectations regarding the future course of monetary policy. Fed funds futures now suggest no likely policy action in the near term. However, futures contracts for late summer and early fall embed an increasing expectation of a modest rise in the intended funds rate. In recent weeks, the yield on one-year Treasury bills has moved persistently above the effective federal funds rate. Moreover, intermediate-term interest rates have tended to rise with maturity length.

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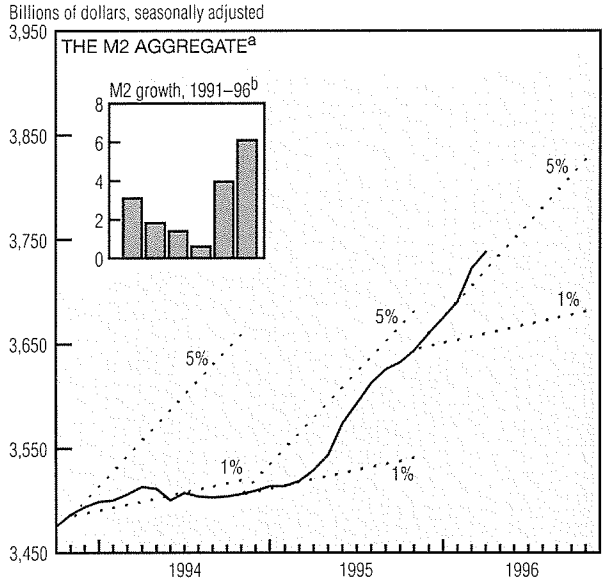
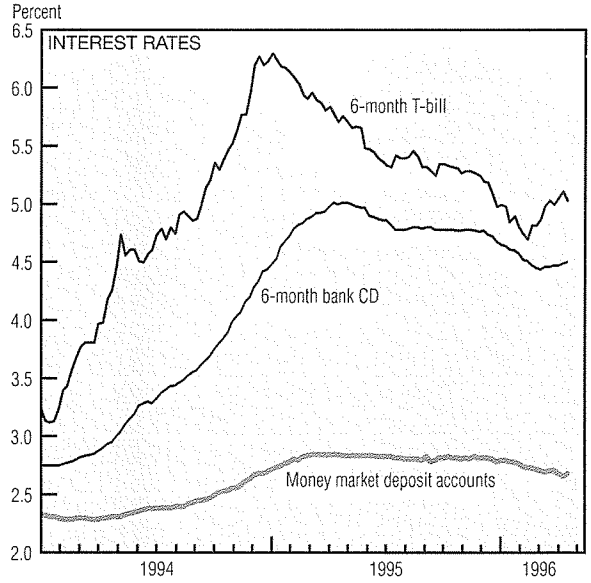
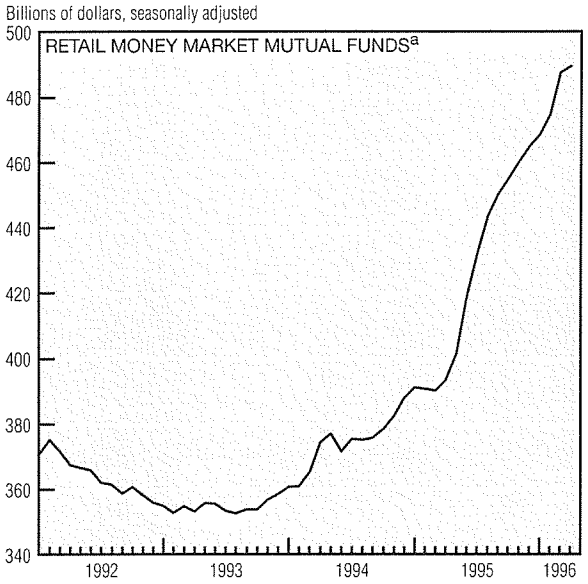
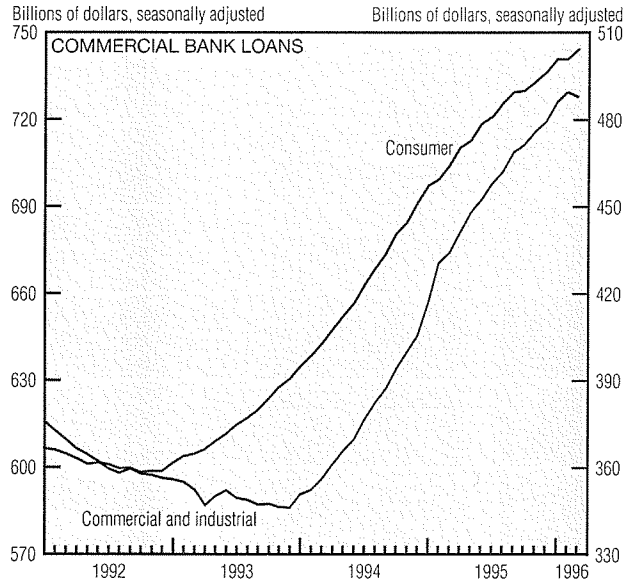
Monetary Policy (cont.)









a. Last plot is estimated for April 1996.
b. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1996 is calculated on an estimated April over 1995:IVQ basis.
NOTE: Dotted lines are target ranges.
SOURCES: Board of Governors of the Federal Reserve System; and *Bank Rate Monitor,* various issues.

M2 growth so far in 1996 has exceeded its average growth rate in each of the past five years. This strength has persisted since about mid-1995, largely reflecting the lagged effects of falling interest rates. Bank deposit rates adjust relatively slowly to market conditions. Thus, the opportunity cost of M2 (measured as the difference between the three-month Treasury yield and the share-weighted average yield paid on M2 components) tends to rise and fall with market rates.

The opportunity cost of M2 had been falling until the turnaround in short-term Treasury yields early this year. The recent rise in short-term rates is associated with a rise in M2's opportunity cost and hence with an expected moderation in M2 growth over the balance of the year.

Retail money market mutual funds are a key component driving the aggregate's recent strength. Money fund yields have tended to rise relative to savings and small time deposit rates, making these funds comparatively attractive. Moreover, the flattening of the yield curve, which persisted through early 1996, induced some investors to shorten the maturity of their portfolios.

Bank loan growth continues to moderate. Commercial and industrial loans fell slightly in March, reflecting in part a reduction of inventories, often financed by a drawing down of bank credit lines. Consumer credit continues to grow, but at a slower rate than previously.

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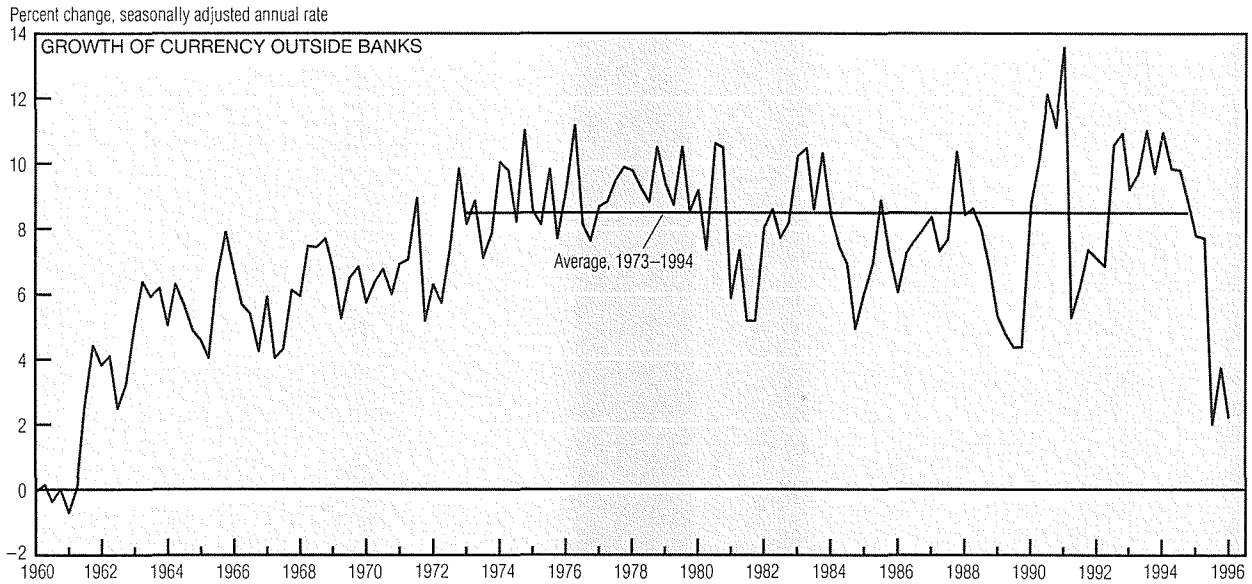

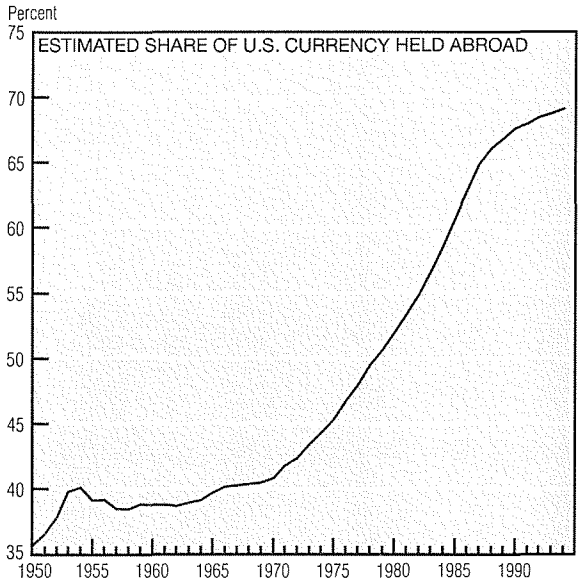

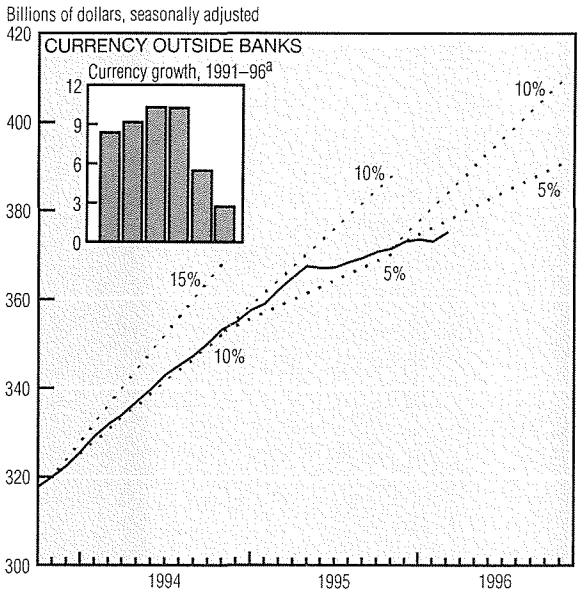

a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1996 is calculated on a March over 1995:IVQ basis.

NOTE: Dotted lines represent growth ranges and are for reference only.

SOURCES: Board of Governors of the Federal Reserve System; and Richard D. Porter and Ruth A. Judson, "The Location of U.S. Currency: How Much Is Abroad?" manuscript, Board of Governors of the Federal Reserve System, June 1995.

One recent anomaly has been the sharp deceleration in currency, which has increased only 3% since June 1995. This compares with an average annual rate of nearly 8½% over the previous 22 years. During these years, currency grew slightly faster than GNP, despite periods of high inflation and the increasing use of alternative payment methods.

Recent evidence suggests that a growing share of U.S. currency is held outside the country by individuals who are uncertain about their own currency's future value. To these investors, the dollar is a refuge during times of political and economic uncertainty. Moreover, the dollar is preferred in many countries as an acceptable medium of exchange and as a safe store of value. Some analysts have estimated that as much as 70% of U.S. currency is held abroad.

The recent slowdown in currency growth is believed to be related to foreign concerns surrounding the March introduction of the redesigned $100 bill, one of the most popular denominations held abroad. The new bill, introduced as an anti-counterfeiting measure, raised questions about the genuineness of existing foreign-held stocks and is believed to be the key explanation for the sudden slowdown in demand. Although March saw currency accelerate to its fastest rate in more than a year, growth remains well below its longer-term pace.