Immediately after its March 25 meeting, the Federal Open Market Committee (FOMC) of the Federal Reserve System announced that it had "decided to tighten money market conditions slightly, expecting the federal funds rate to rise 1/4 percentage point to around 5 1/2 percent." This was the Committee's first policy move in almost 14 months and the first increase since January 1995.

This action was no surprise to financial markets. The fed funds futures market, for instance, had come to anticipate the rate increase in the weeks before the meeting. Although futures prices in January had indicated the likelihood of a rate hike in March, February events led futures investors to doubt that any policy action would occur before midyear. Capital markets in February also seemed to discount any immediate move by the FOMC. However, concerns about growing inflationary pressures arose by mid-March, and the likelihood of a modest rate hike increased.

In announcing its action, the FOMC stated that "... the slight firming of monetary conditions is viewed as a prudent step that affords greater assurance of prolonging the current economic expansion by sustaining the existing low inflation environment through the rest of this year and next. The experience of the last several years has reinforced the conviction that low inflation is essential to realizing the economy's fullest growth potential."

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Monetary Policy (cont.)

To understand this perspective, it is useful to review monetary policy over the past few decades. From the mid-1960s to the late 1970s, each business cycle ended with inflation higher than the previous peak and began with inflation higher than the previous trough. This upward trend was accompanied by increasing structural imbalance and a general deterioration in the economy's growth potential. Assets considered to be inflation hedges (such as housing and gold) appreciated beyond sustainable levels. In 1979, uncertainty about the future of the dollar led to a sharp decline in its value and precipitated a significant FOMC commitment to a policy of disinflation.

Disinflation climaxed in 1982 and was followed by a prolonged period of robust growth and relatively low inflation. Both nominal and real interest rates, however, stayed relatively high as investors in long-term debt instruments remained leery of the Fed’s commitment to price stability. Indeed, market rates rose sharply throughout 1983 and early 1984. Many attributed this, in part, to a high rate of return on new business investment resulting from fiscal incentives and reduced tax rates. However, many also believed that part of the increase reflected an inflation scare, as investors waited for evidence that inflation was not accelerating. In 1985, financial markets became more confident that inflation was contained, and interest rates generally fell.

Inflationary pressures emerged again in 1987, and the Fed adopted an anti-inflationary stance. A sharp drop in stock prices in October, however, aroused concern about market liquidity and interrupted anti-inflationary efforts. Eventually, policy was redirected to containing inflation, but not in time to head off a...

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jump in the trend of core inflation to nearly 5% in the spring of 1988. The inflation rate eventually dropped sharply with the resolution of the Gulf War in 1991 and trended down to just below 3%, where it has remained since mid-1992.

Although the 1991 recovery started slowly, it gained momentum as the last vestiges of high inflation were worked out. In 1994, the threat of inflation produced a preemptive policy stance that did not interfere with continued economic expansion. Indeed, the economy accelerated in 1996, while inflation remained well behaved. This experience demonstrates that the FOMC’s commitment to price stability since 1982 has enabled extended periods of high growth and employment, along with low inflation. Consistent policy throughout this period has also been associated with a general decline in nominal GDP, but only one recession. Moreover, real interest rates have fallen from their 1980s highs as the Fed’s credibility has increased. Vigilance in the pursuit of price stability requires that policymakers pay close attention to any sign of inflationary pressures. Although the Fed de-emphasized money growth targeting in 1993, M2 growth since then has been in line with its historical relationship to economic activity. Over the past year, there has been an acceleration across the M2, M3, and MZM aggregates. The recent uptick in the federal funds rate reduces the likelihood that M2 and M3 will continue to exceed their announced growth ranges.