It has been more than three months since the Federal Open Market Committee (FOMC) raised the intended federal funds rate from 5 1/4% to 5 3/4%. This rate hike was the first policy move in 14 months and the first increase in more than two years. By taking this action, the FOMC served notice that it stood ready to address incipient inflationary pressures.

In announcing the rate increase, the Committee 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."

The policy move was no surprise to financial markets. The federal funds futures market, for instance, had come to anticipate the rate increase in the weeks before the meeting. In the period immediately following the Fed's action, futures prices revealed that investors were expecting another rate hike by midyear. Since then, however, the inflation news has been favorable, and futures prices currently suggest that no imminent policy move is anticipated.

Money market interest rates rose in concert with the increased federal funds rate. Because the interest rate paid on bank deposits tends to respond slowly to changes in market rates, the opportunity cost of deposits (the interest forgone on holding deposits compared with a market alternative) has risen. For example, the 3-year Treasury note

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Monetary Policy (cont.)

now yields almost 100 basis points more than a deposit of comparable term. The spread between the 6-month Treasury bill and the share-weighted average of rates paid on M2 deposits also widened substantially.

The higher opportunity cost of deposits reduces their attractiveness relative to market alternatives. Thus, the rise in opportunity cost has been associated with a slowdown in the growth rate of all the monetary aggregates. Early this year, M2 exceeded the 5% upper bound of its FOMC-determined provisional range. In May, M2 decelerated and now stands within the specified range. The M2M aggregate, which had been expanding at nearly a 9% pace in the first few months of the year, declined in May and is expected to follow a flatter trajectory over the balance of 1997.

The recent deceleration in M2 and M2M reflects more than the increase in their opportunity costs. The unexpected strength in economic activity led to larger-than-expected tax payments, which were accumulated in bank deposits. As payments cleared in May, the bulge in the aggregates dissipated.

Banks continue to find robust demand for commercial and industrial loans. To a great extent, these loans have been financed with negotiable CDs, which are included in M3 but not in M2. Hence, M3 continues to expand more rapidly than M2 and remains above the upper bound of its specified range.

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Monetary Policy (cont.)

Since July 1993, the FOMC has not paid a great deal of attention to the growth rate of the monetary aggregates. At that time, M2 was downgraded as a reliable indicator of monetary policy. The breakdown in its relationship with economic activity is reflected in a change in the relationship between M2 velocity—the ratio of GDP to M2—and its opportunity cost. Before 1990, M2 velocity tended to vary directly with opportunity cost. In 1990, however, velocity jumped sharply despite a fall in opportunity cost.

The discrepancy was largely concentrated in small time deposits, which plummeted as a share of M2. Balance holders transferred a large share of their funds to stock and bond mutual funds, which expanded markedly over this period. Since about 1994, however, the old relationship has begun to reemerge. M2 velocity again varies directly with opportunity cost, but around a much higher average level.

M2M does not include time deposits. Thus, M2M velocity was unaffected by the shift from small time deposits to stock and bond funds, as is evident in the relationship between the aggregate's velocity and its opportunity cost. Prior to 1975, however, velocity grew rapidly as funds were transferred from savings deposits to small time deposits, which are included in M2. The consequent shift in M2M velocity stabilized and has remained intact for more than 20 years.

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