At its May 16 meeting, the Federal Open Market Committee (FOMC) voted to raise the federal funds target rate 50 basis points (bp) to 6.5%. The FOMC began the current round of increases in June 1999 and, until its most recent meeting, had raised the target rate by 25 bp increments in a remarkably steady manner. In fact, the Committee held to this pattern at five of the seven meetings previous to May; one could argue that only extraordinary circumstances, created by the century date change, prevented action at the December 1999 meeting. The Committee’s press release cited potential inflationary imbalances fostered by continued growth in demand, which exceeded “even the rapid pace of productivity-driven gains in potential supply,” as the reason for its more aggressive move of 50 bp.

Implied yields on fed funds futures, a widely used indicator of the expected policy path, reveal that market participants assigned a high probability to an increase of more than 25 bp. Expectations of future increases rose immediately after the announcement but have since returned to their pre-meeting levels. On May 26, the November contract traded at 7.08%, 58 bp above the current target rate.

Although we may have become used to increases of 25 bp, considerably larger ones are not uncommon. Compared to other periods when the FOMC raised rates, the current episode is relatively mild. The monthly average for the effective federal funds rate shows that since the mid-1950s, the maximum cumulative increase (which occurred between March 1972 and September 1973), was nearly 7.5 percentage points.

Sources: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.
points. Moreover, the cumulative increase in the intended rate since June 1999 (1.75 percentage points) is more than a full percentage point lower than the median increase in the effective rate 11 months after the start of an episode of rate increases.

Both long- and short-term interest rates moved sharply upward after the FOMC’s May announcement. The 3-month and 1-year Treasury bills reached 6.06% and 6.40%, up 73 bp and 45 bp on the year, respectively. The 10-year Treasury bond yield regained ground (up 8 bp on the year at 6.49%). Yields on the 30-year Treasury bond made some gains but remain depressed (down 27 bp on the year at 6.19%).

The monetary aggregates show signs of slowing in the face of higher interest rates. Annualized growth in the sweep-adjusted monetary base (2.37%) shows the most dramatic reversal; however, annualized M2 growth is also lower than in recent years. The growth of these monetary aggregates, fairly robust in the latter years of the current expansion, now appears to be decelerating.

Ever since Federal Reserve Chairman Alan Greenspan uttered the now-famous phrase “irrational exuberance” in late 1996, there has been growing debate over whether the Fed should respond to asset prices. Many central bankers maintain that using interest rates to respond to stock markets—and possibly to manipulate them—is dangerous. Nonetheless, central banks (continued on next page)
Monetary Policy (cont.)

almost certainly react to significant stock market moves, such as the 1987 crash. In that instance, the Federal Reserve lowered interest rates immediately, opening the spigot for more rapid money growth. To a lesser extent, the same action followed the Russian default crisis in 1998. These events, however, were immediate reactions to a potential financial crisis rather than a concerted response to the market.

Whether central banks systematically increase interest rates when stock markets rise over an extended period is more germane to the current debate. Some fear that increased paper wealth will spill over into rapid consumer spending, thereby igniting inflation.

Evidence that the stock market causes inflation is weak at best. There is little discernible correlation between CPI inflation and the S&P 500 growth rate. The two tracked each other fairly closely in the 1970s and early 1980s, but this is the exception, not the rule. Given the twin recessions during the period, moreover, many argue that even this correlation is spurious—a reaction to changes in underlying economic conditions, not in the stock market.

Cross-country evidence suggests that only in a minority of countries do stock markets contribute to inflation, after controlling for its usual causes. In only 25% of countries did lagged stock market growth over a one-year horizon help to explain inflation variability. In contrast, lagged inflation contributed to inflation variability in 100% of countries and lagged changes in money in

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58%. Lagged GDP growth is a better inflation predictor than stock market growth, although it was significant in only one-third of countries.

Monetary policy—as defined by changes in the fed funds rate—does not usually respond directly to the stock market. Money growth, as defined by M2, is highly correlated with the stock market, but even this relationship apparently broke down in the 1990s. The correlation does not reflect a concerted effort of the central bank to increase M2 in response to the stock market, however. Stock market transactions are frequently conducted in M2 assets; thus, the demand for M2 generally increases with the stock market. This change is driven by the market, not by policy.

Increases in M2 over longer time horizons lead to increased inflation, explaining the weak correlation between CPI inflation and stock market growth. Because high money growth over long periods inevitably leads to inflation, some argue that central banks should defuse market-driven money growth by increasing the fed funds rate. This argument has merit, but it has more to do with whether central banks should target M2 growth rather than the stock market. Evidence suggests that policymakers should be concerned with rapid and sustained M2 growth, not with transitory changes in money growth.