

This issue of *Monetary Trends* will be the final printed copy.
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A Neutral Federal Funds Rate?

The stance of monetary policy with respect to aggregate demand is widely measured in terms of the Federal Reserve Open Market Committee's (FOMC) federal funds rate target. Too low a target, it is suggested, will cause the Open Market Desk to inject too much liquidity, "overstimulating" aggregate demand and increasing the inflation rate. Too high a target will result in undue pressures on liquidity, unnecessarily high market interest rates, and slower-than-desired economic activity. Like Goldilocks exploring the three bears' forest home, many analysts appear to believe there exists a "just right," or neutral, target between the two extremes. But what exactly is a neutral monetary policy and is it possible to achieve it?

A neutral level of the federal funds rate often is discussed as having two properties. First, it is a level that neither stimulates nor slows output relative to potential. Second, it is a moving target that varies from one period to another. But such a characterization raises an interesting question: If the neutral rate changes frequently, can it be measured accurately and does the concept have any value for policymakers?

Arguments for the existence of a steady-state neutral federal funds rate frequently begin with the assertion that the historical record suggests bounds for the neutral rate, say, greater than 1 percent and less than 10 percent, and that the task is to narrow that range, perhaps to a single number. One oft-made claim is that the neutral rate, in the long run, should equal the sum of the growth rate of potential real GDP plus the target inflation rate. The Congressional Budget Office projects that real potential GDP will grow at approximately a 3.1 percent rate during 2004-05, with similar growth rates in later years. If measured inflation is to be in the neighborhood of 2 percent with no expectation of an increase or decrease, then a neutral funds rate target might be slightly greater than 5 percent.

This analysis, however, does not allow for the typical upward slope of yield curves—that is, for a positive term premium. Macroeconomic steady-state growth models often assume a horizontal yield curve, thereby excluding

such a premium. In financial markets, however, yields on longer-term assets typically are higher than those on shorter-term assets. To estimate a neutral overnight federal funds rate target, we need to isolate the maturity-related term premium from the inflation-related risk premium that is included in longer-maturity yields as a result of uncertainty regarding future inflation. One possibility is to observe maturity-related Treasury rate spreads during a period when market participants expect future inflation rates to be approximately unchanged from their then-current pace. The figure shows the rate spread between the 10-year Treasury constant-maturity yield and the bond-equivalent yield on 3-month Treasury bills. It seems likely that the inflation-uncertainty risk premium was approximately zero during the early 1960s and the mid-1990s, suggesting a maturity-related rate spread of approximately 150 to 200 basis points. Subtracting this spread from the previous 5 percent rate suggests a neutral overnight federal funds rate of approximately 3 to 3½ percent.

Recent public statements by FOMC members have suggested a range for a neutral funds target of between 3½ and 5½ percent. Allowing for the typical positive slope of the yield curve suggests that the neutral federal funds target is more likely to be near the lower than the upper end of this range.

—Richard G. Anderson, Jason J. Buol, and Robert H. Rasche

Slope of Treasury Yield Curve

10-Year Constant Maturity Minus 3-Month T-Bill



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Conventions used in this publication:

1. Unless otherwise indicated, data are monthly.
2. Shaded areas indicate recessions, as determined by the National Bureau of Economic Research.
3. *Percent change at an annual rate* is the simple, not compounded, monthly percent change multiplied by 12. For example, using consecutive months, the percent change at an annual rate in x between month $t-1$ and the current month t is: $[(x_t/x_{t-1})-1] \times 1200$. Note that this differs from *National Economic Trends*. In that publication, monthly percent changes are compounded and expressed as annual growth rates.
4. The *percent change from year ago* refers to the percent change from the same period in the previous year. For example, the percent change from year ago in x between month $t-12$ and the current month t is: $[(x_t/x_{t-12})-1] \times 100$.

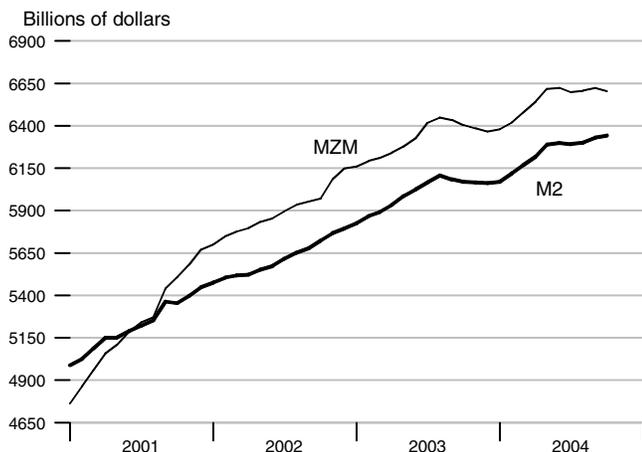
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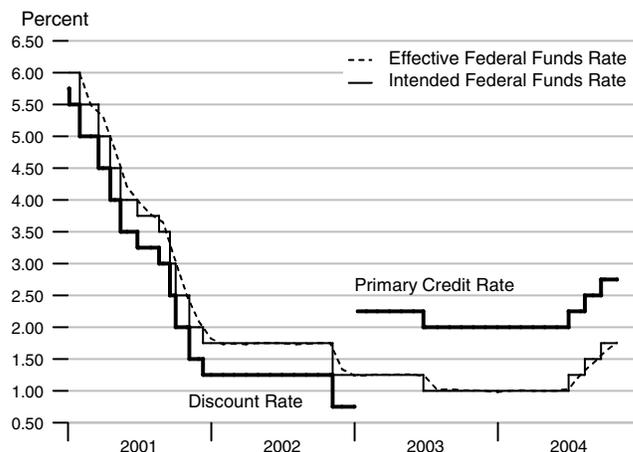
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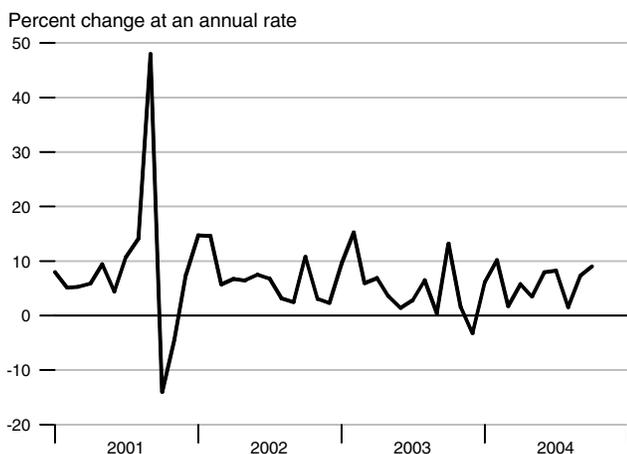
M2 and MZM



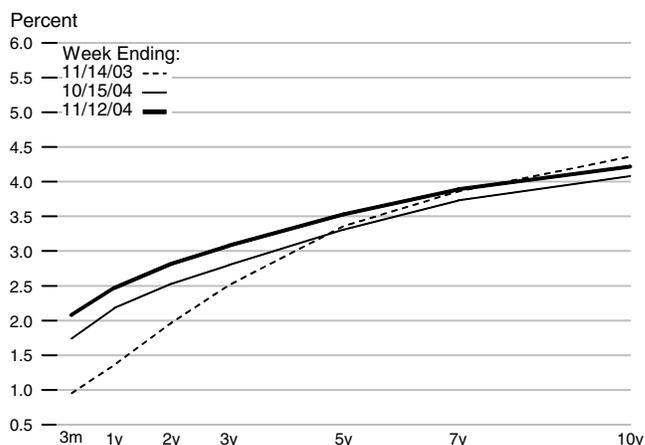
Reserve Market Rates



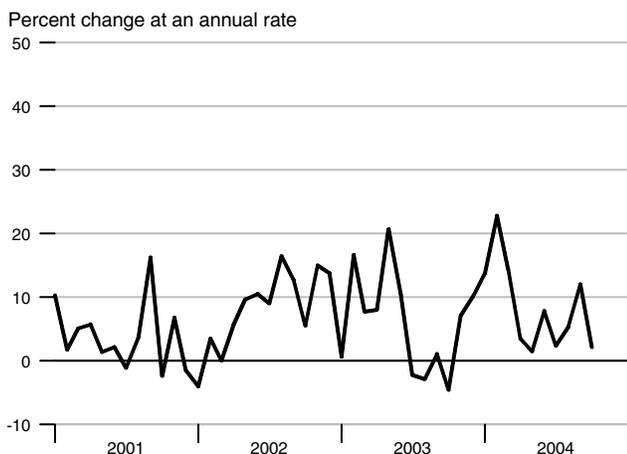
Adjusted Monetary Base



Treasury Yield Curve



Total Bank Credit

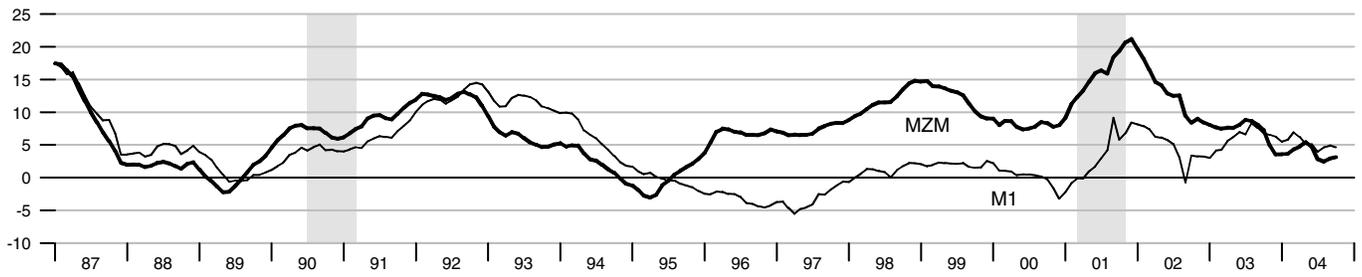


Interest Rates

| | Aug 04 | Sep 04 | Oct 04 |
|----------------------------|--------|--------|--------|
| Federal Funds Rate | 1.43 | 1.61 | 1.76 |
| Prime Rate | 4.43 | 4.58 | 4.75 |
| Primary Credit Rate | 2.43 | 2.58 | 2.75 |
| Conventional Mortgage Rate | 5.87 | 5.75 | 5.72 |
| Treasury Yields: | | | |
| 3-Month Constant Maturity | 1.50 | 1.68 | 1.79 |
| 6-Month Constant Maturity | 1.76 | 1.91 | 2.05 |
| 1-Year Constant Maturity | 2.02 | 2.12 | 2.23 |
| 3-Year Constant Maturity | 2.88 | 2.83 | 2.85 |
| 5-Year Constant Maturity | 3.47 | 3.36 | 3.35 |
| 10-Year Constant Maturity | 4.28 | 4.13 | 4.10 |

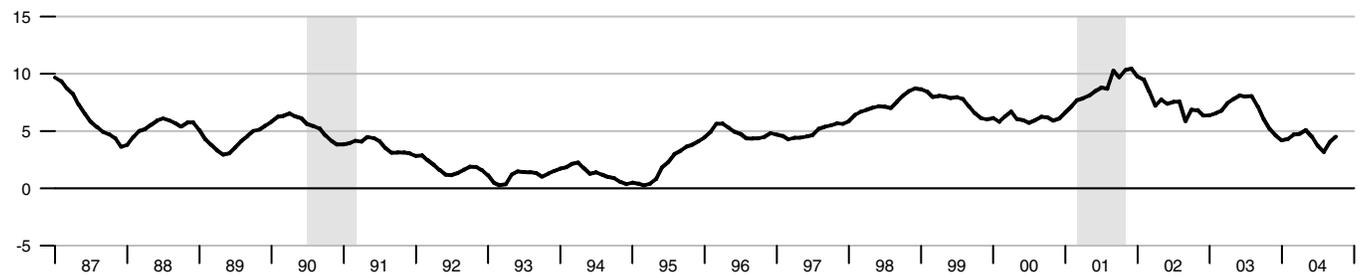
MZM and M1

Percent change from year ago



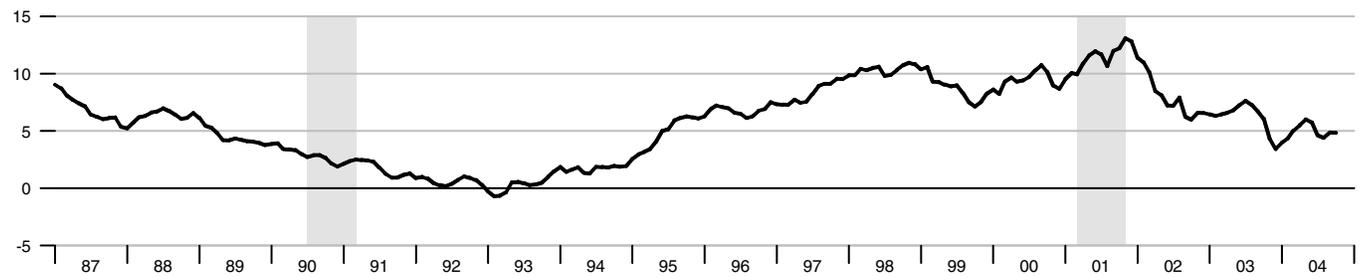
M2

Percent change from year ago



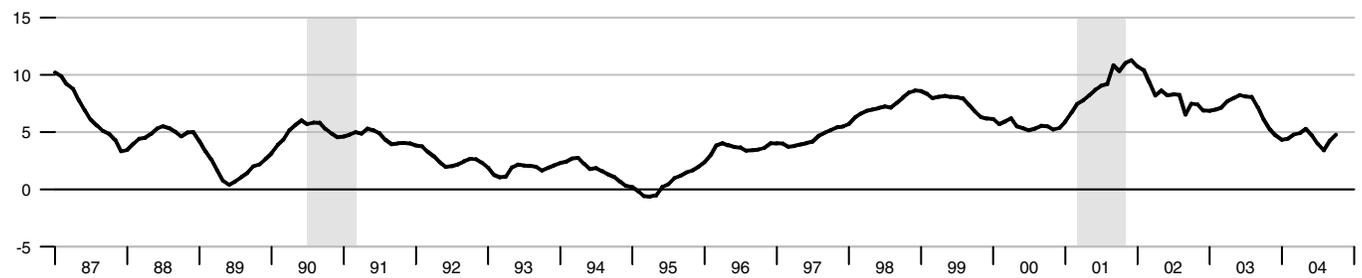
M3

Percent change from year ago



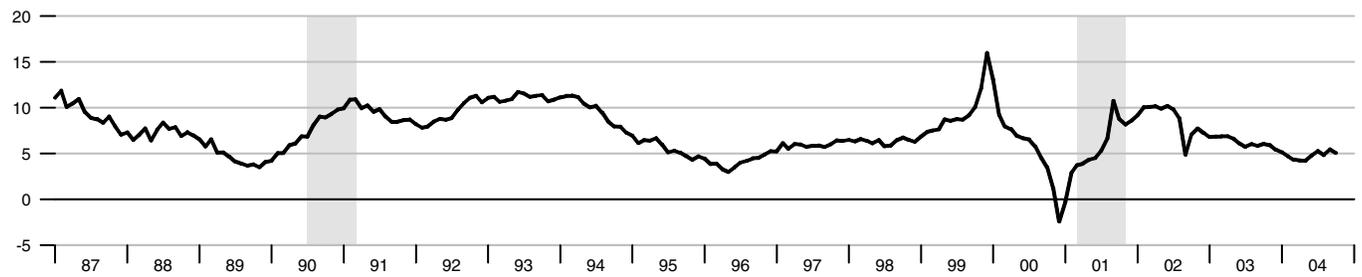
Monetary Services Index - M2

Percent change from year ago



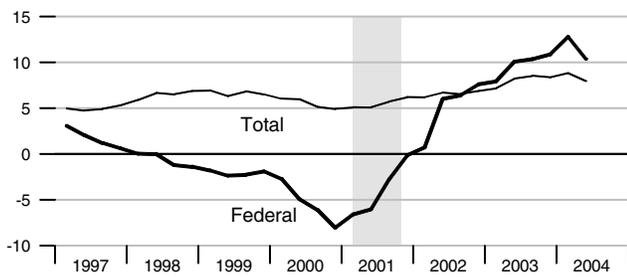
Adjusted Monetary Base

Percent change from year ago



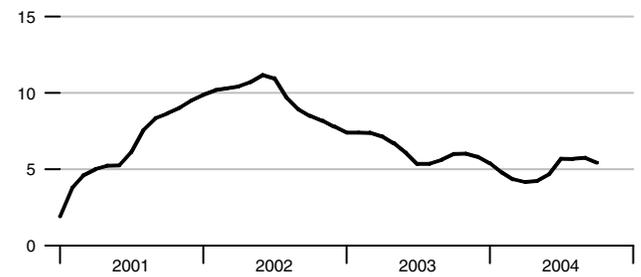
Domestic Nonfinancial Debt

Percent change from year ago



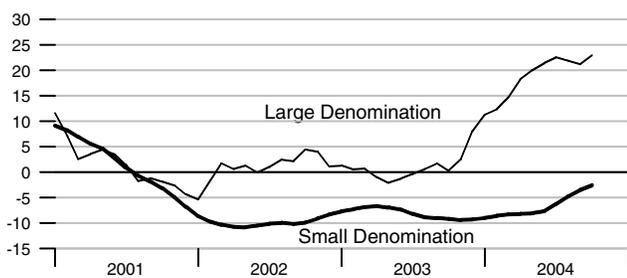
Currency Held by the Nonbank Public

Percent change from year ago



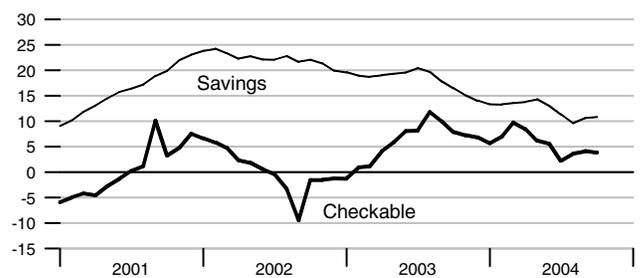
Time Deposits

Percent change from year ago



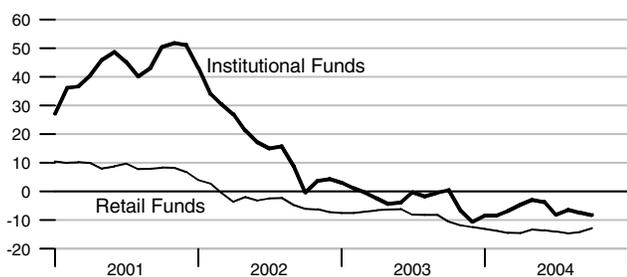
Checkable and Savings Deposits

Percent change from year ago



Money Market Mutual Fund Shares

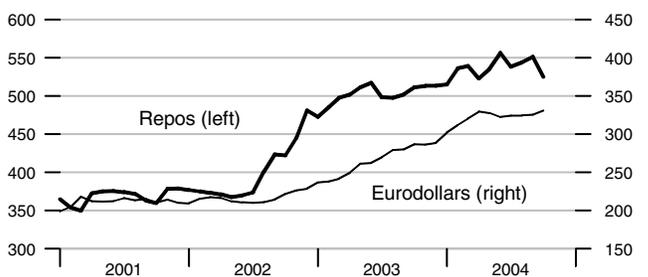
Percent change from year ago



Repurchase Agreements and Eurodollars

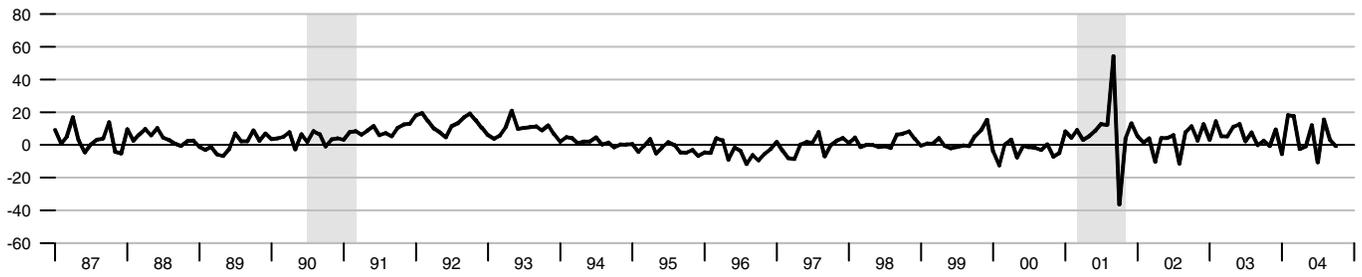
Billions of dollars

Billions of dollars



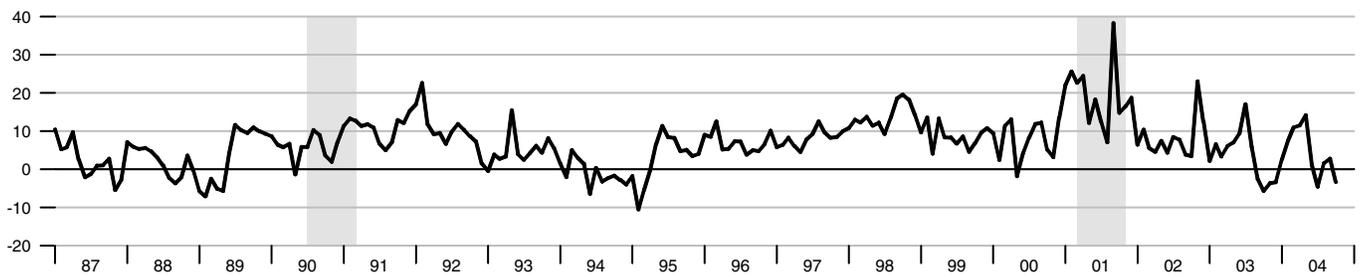
M1

Percent change at an annual rate



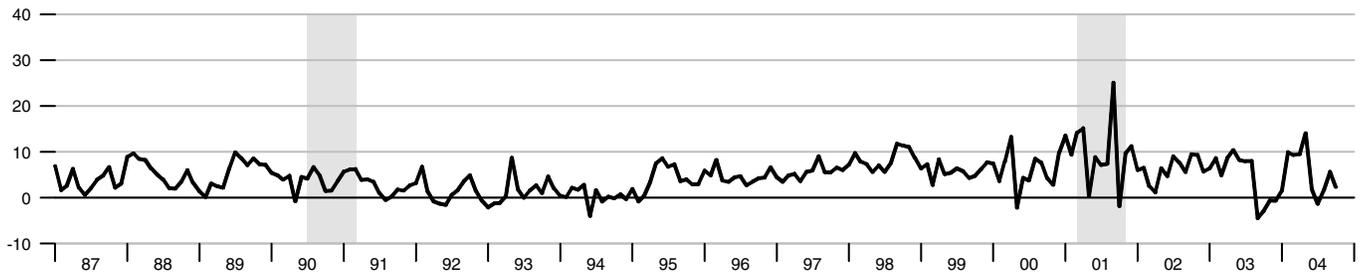
M2M

Percent change at an annual rate



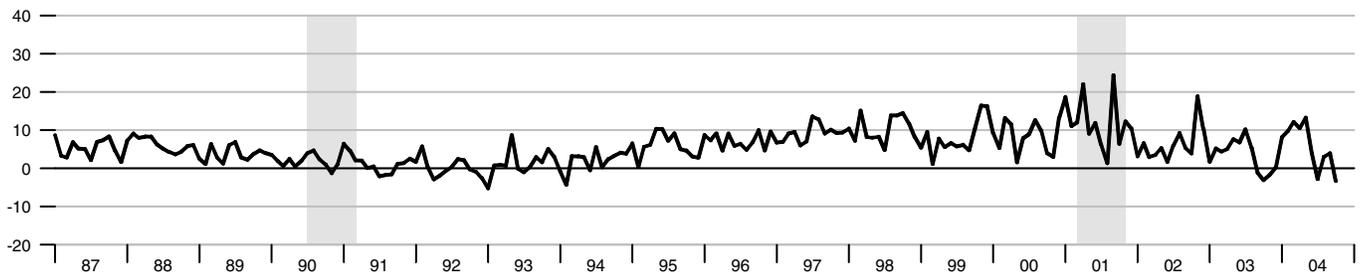
M2

Percent change at an annual rate



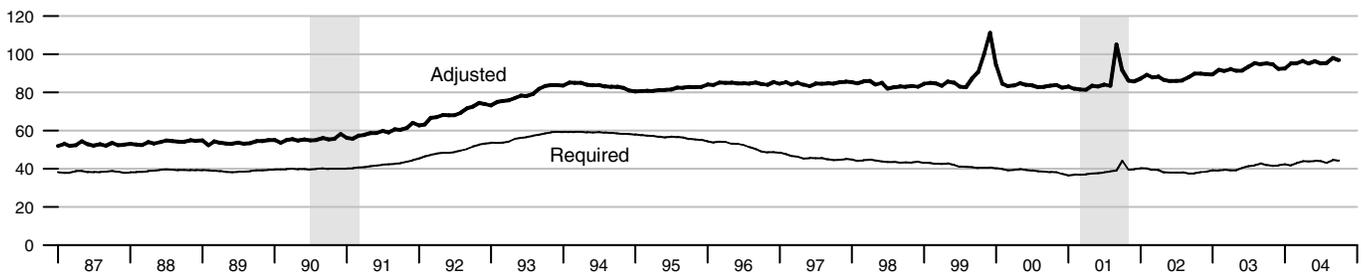
M3

Percent change at an annual rate



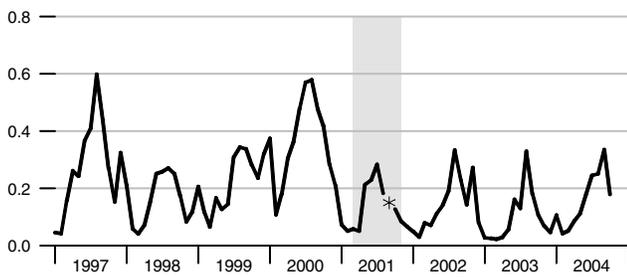
Adjusted and Required Reserves

Billions of dollars



Total Borrowings, nsa

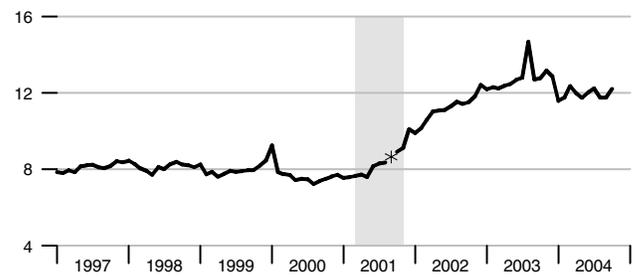
Billions of dollars



*Actual value for September 2001 is \$3.4 billion.

Excess Reserves plus RCB Contracts

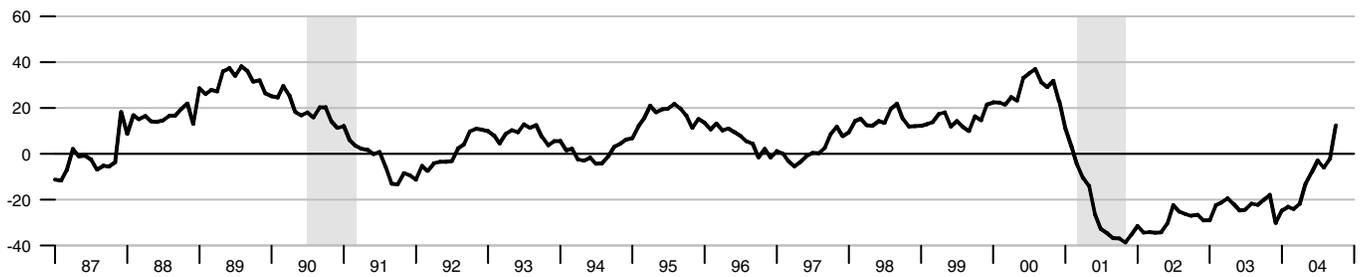
Billions of dollars



*Actual value for September 2001 is \$26.43 billion.

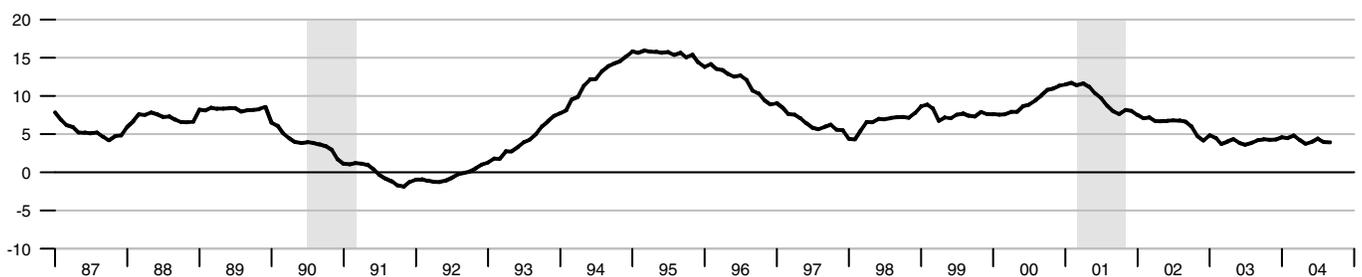
Nonfinancial Commercial Paper

Percent change from year ago

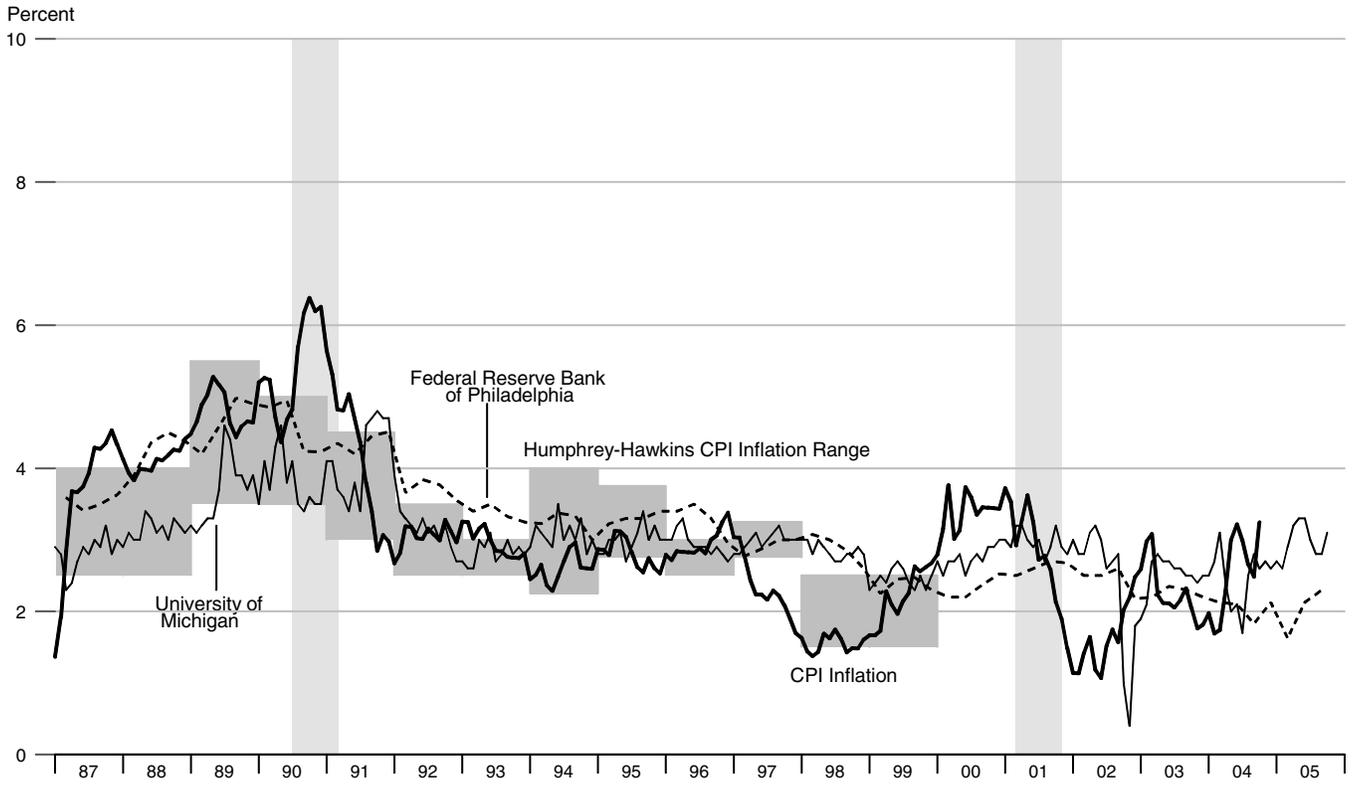


Consumer Credit

Percent change from year ago

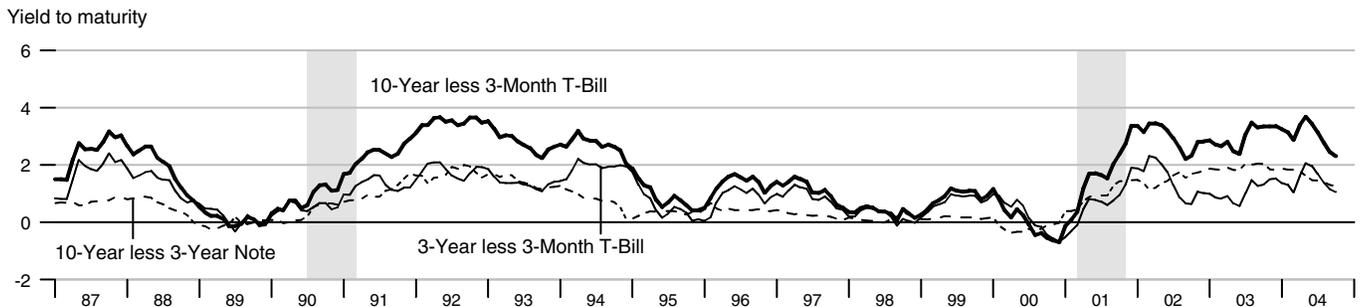


Inflation and Inflation Expectations

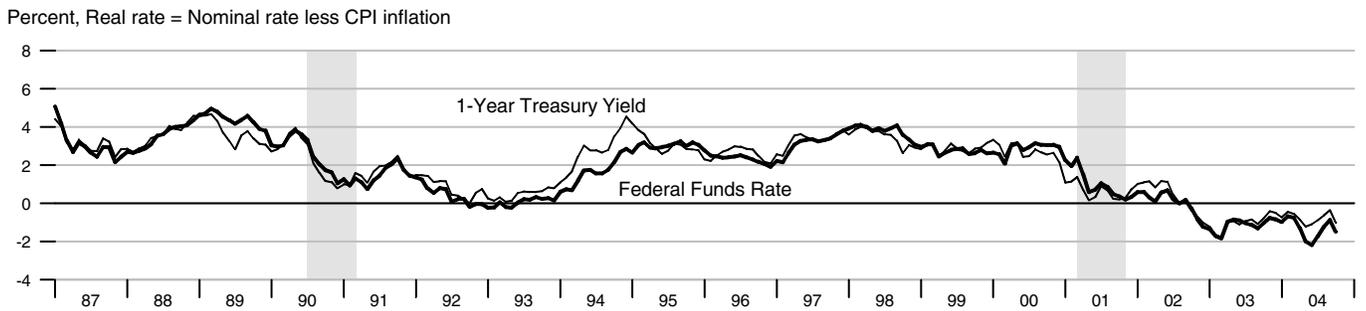


The shaded region shows the Humphrey-Hawkins CPI inflation range. Beginning in January 2000, the Humphrey-Hawkins inflation range was reported using the PCE price index and therefore is not shown on this graph. See notes on page 19.

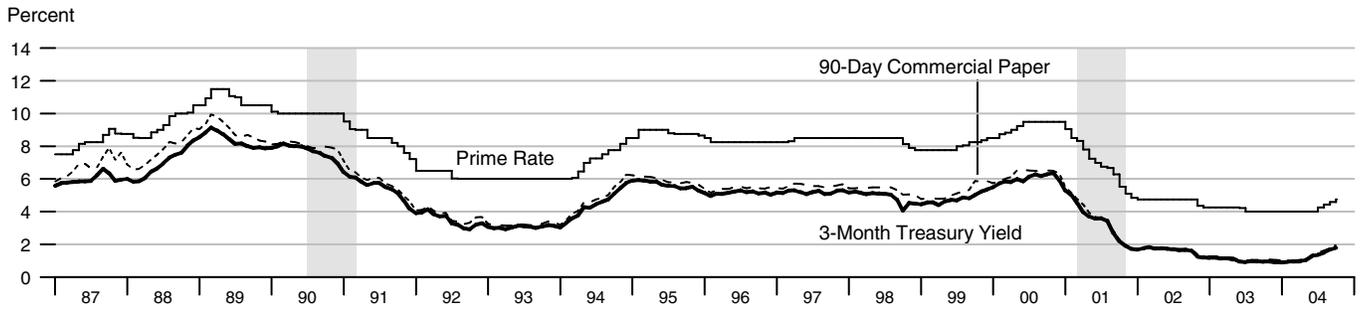
Treasury Security Yield Spreads



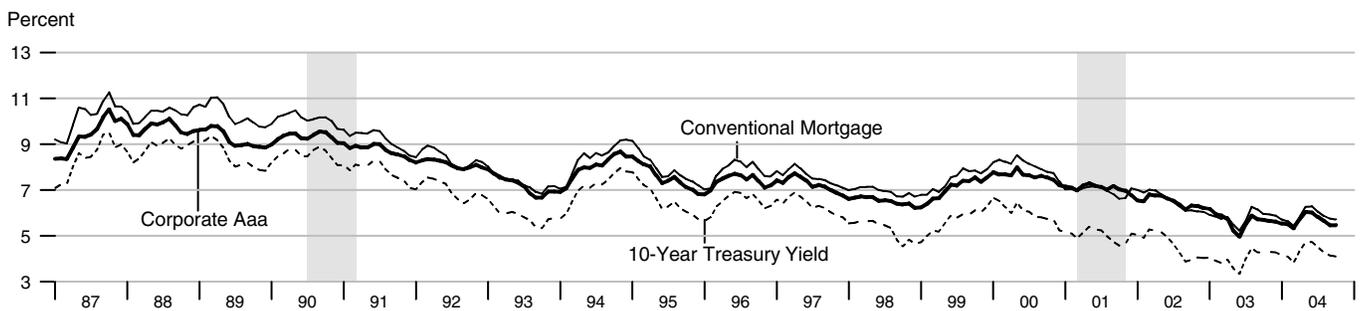
Real Interest Rates



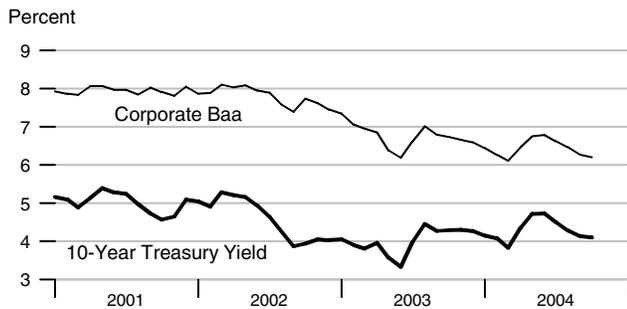
Short-Term Interest Rates



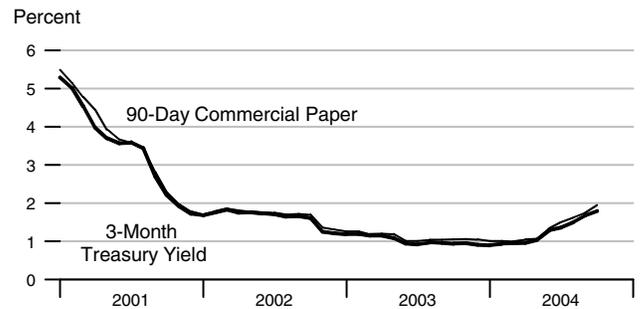
Long-Term Interest Rates



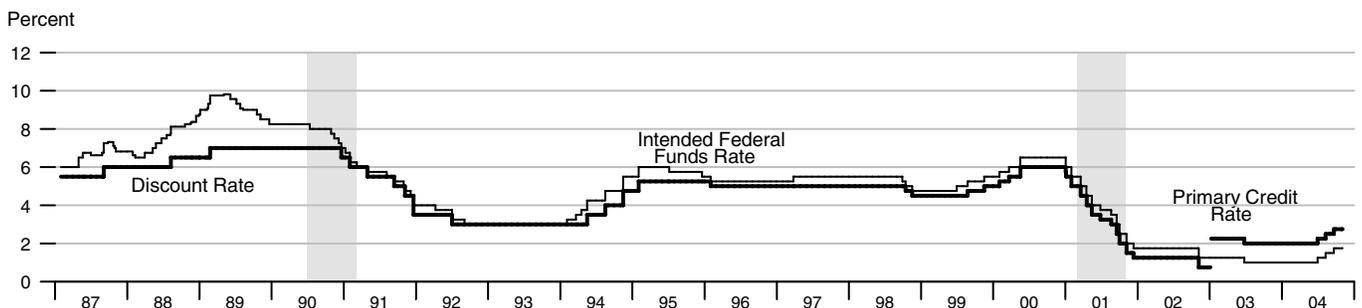
Long-Term Interest Rates



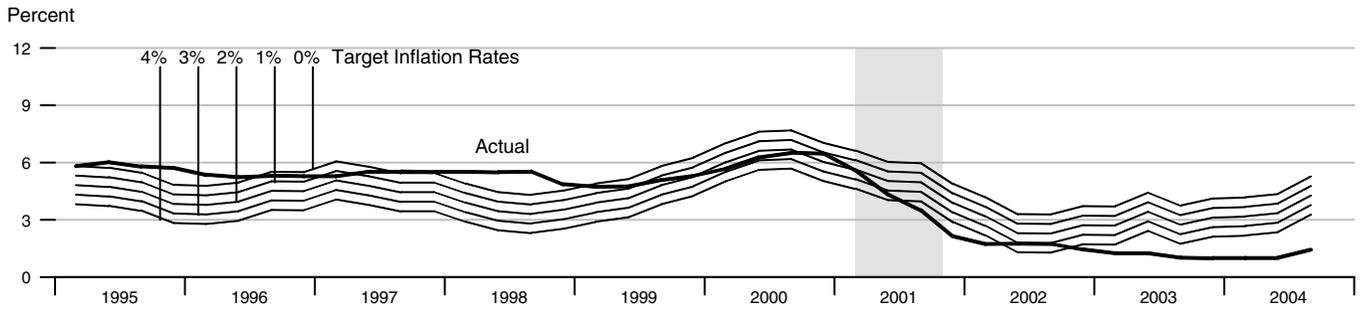
Short-Term Interest Rates



FOMC Intended Federal Funds Rate, Discount Rate, and Primary Credit Rate



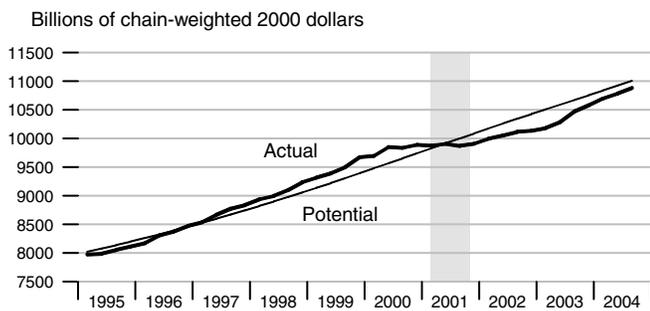
Federal Funds Rate and Inflation Targets



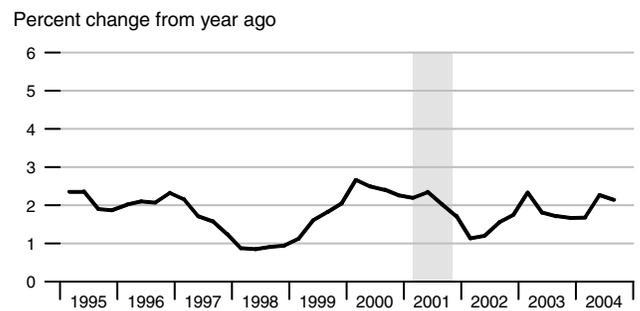
Calculated federal funds rate is based on Taylor's rule. See notes on page 19.

Components of Taylor's Rule

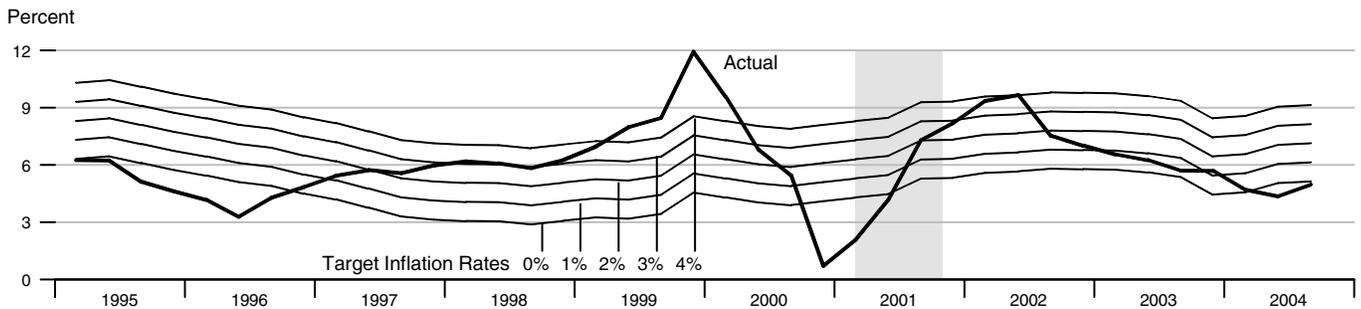
Actual and Potential Real GDP



PCE Inflation



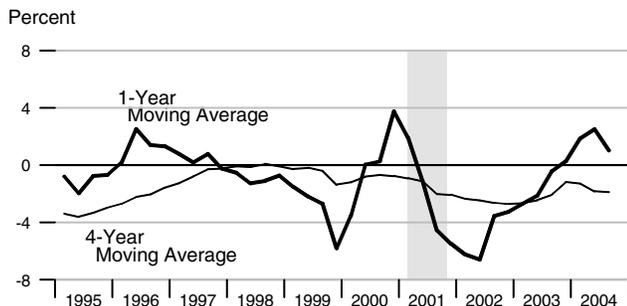
Monetary Base Growth* and Inflation Targets



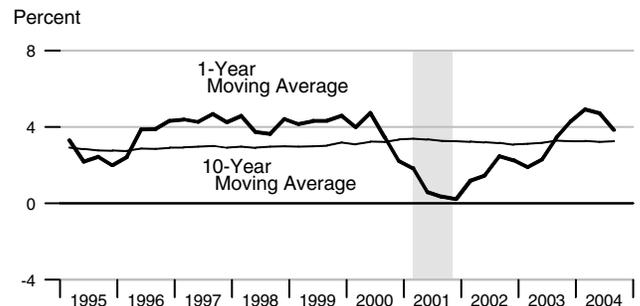
*Modified for the effects of sweeps programs on reserve demand. Calculated base growth is based on McCallum's rule. Actual base growth is percent change from year ago. See notes on page 19.

Components of McCallum's Rule

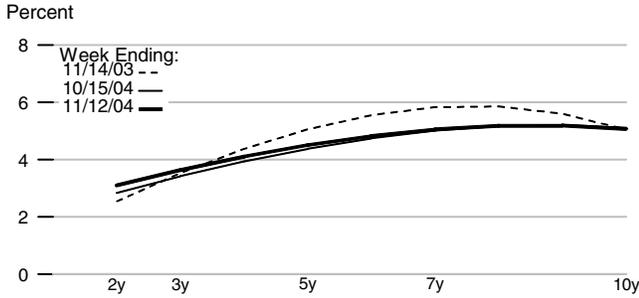
Monetary Base Velocity Growth



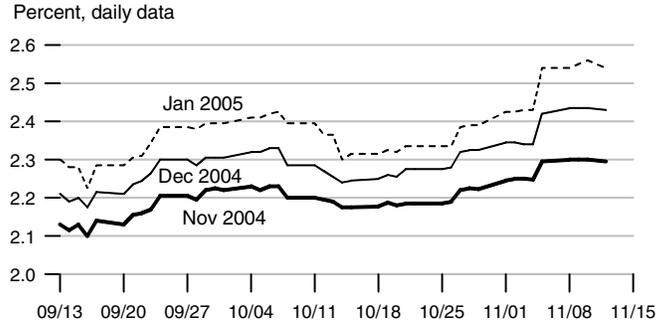
Real Output Growth



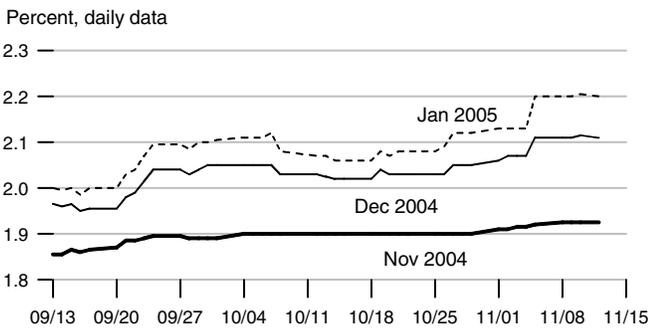
Implied One-Year Forward Rates



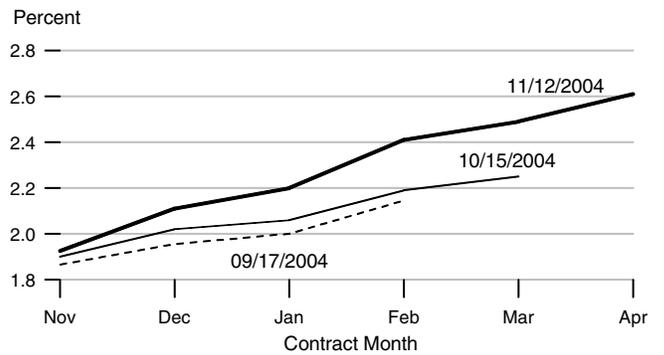
Rates on 3-Month Eurodollar Futures



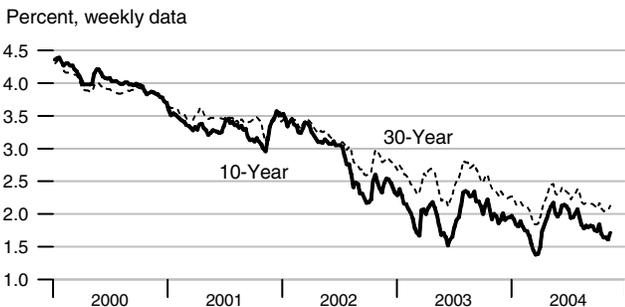
Rates on Selected Federal Funds Futures Contracts



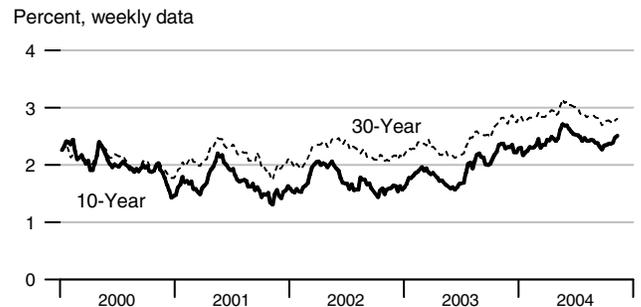
Rates on Federal Funds Futures on Selected Dates



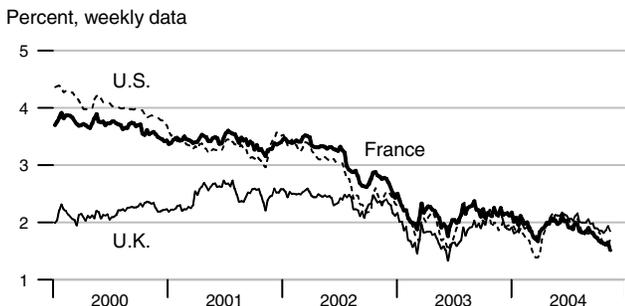
Inflation-Indexed Treasury Securities



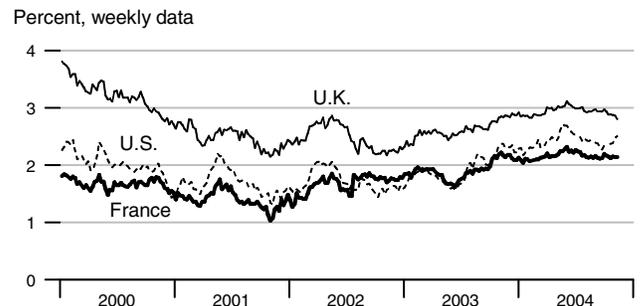
Inflation-Indexed Treasury Yield Spreads



Inflation-Indexed 10-Year Government Notes

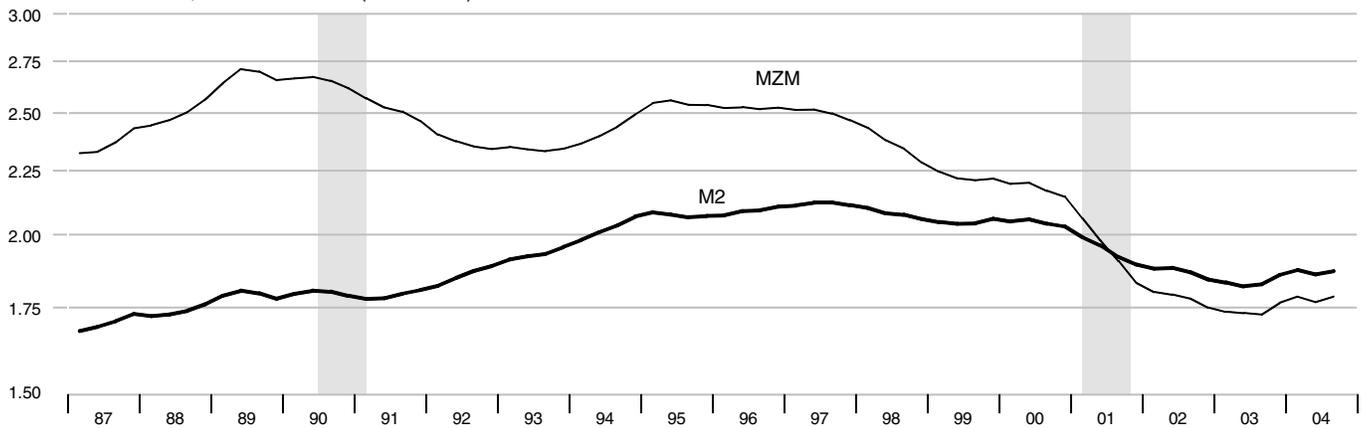


Inflation-Indexed 10-Year Government Yield Spreads



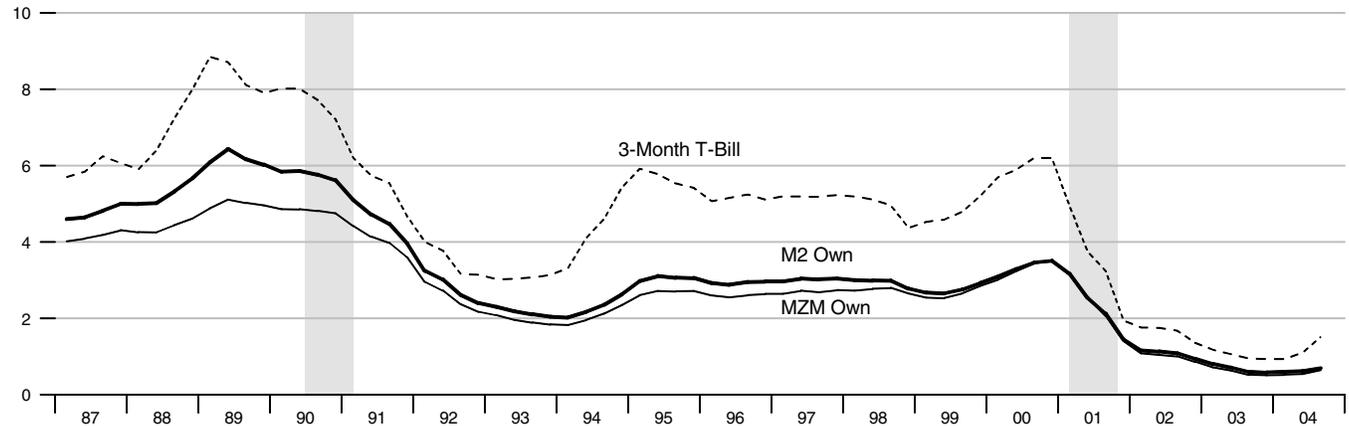
Velocity

Nominal GDP/MZM, Nominal GDP/M2 (Ratio Scale)



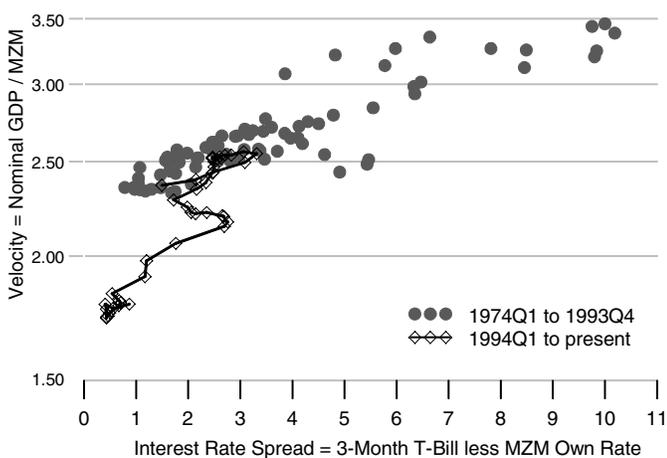
Interest Rates

Percent



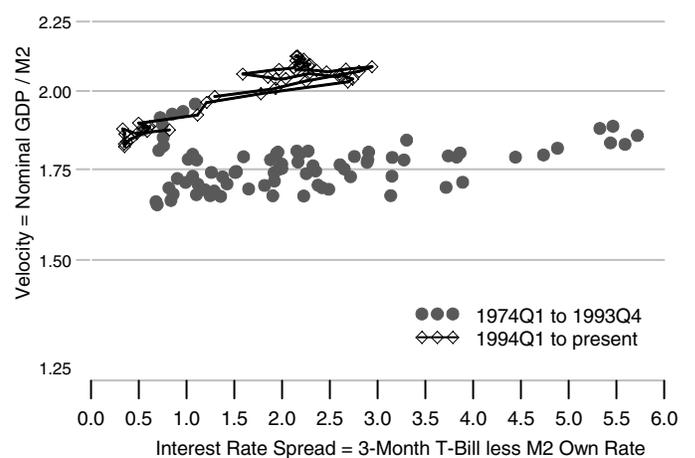
MZM Velocity and Interest Rate Spread

Ratio Scale



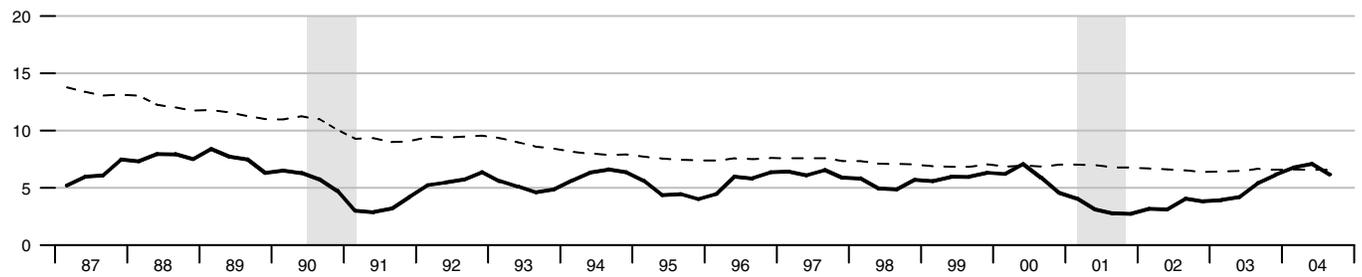
M2 Velocity and Interest Rate Spread

Ratio Scale



Gross Domestic Product

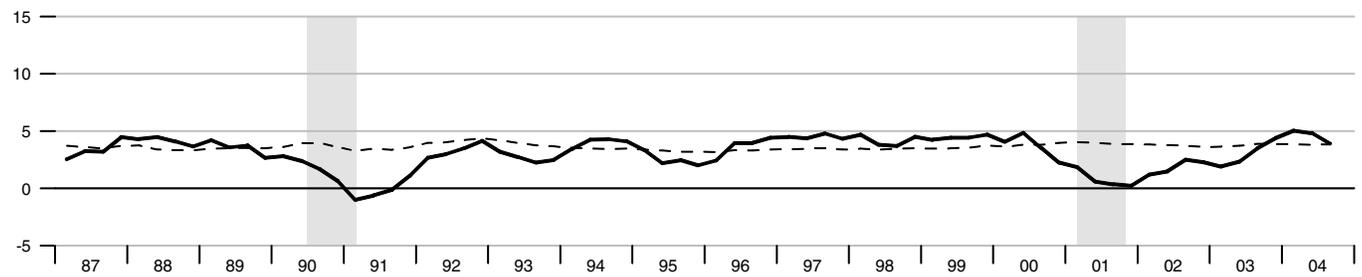
Percent change from year ago



Dashed lines indicate 10-year moving averages.

Real Gross Domestic Product

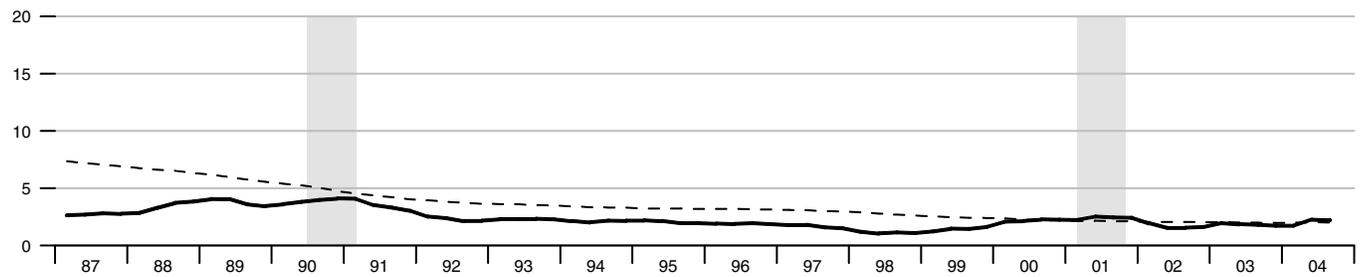
Percent change from year ago



Dashed lines indicate 10-year moving averages.

Gross Domestic Product Price Index

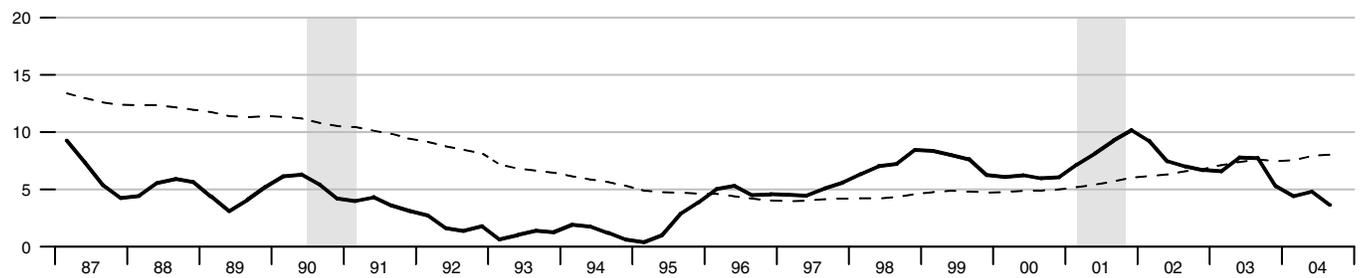
Percent change from year ago



Dashed lines indicate 10-year moving averages.

M2

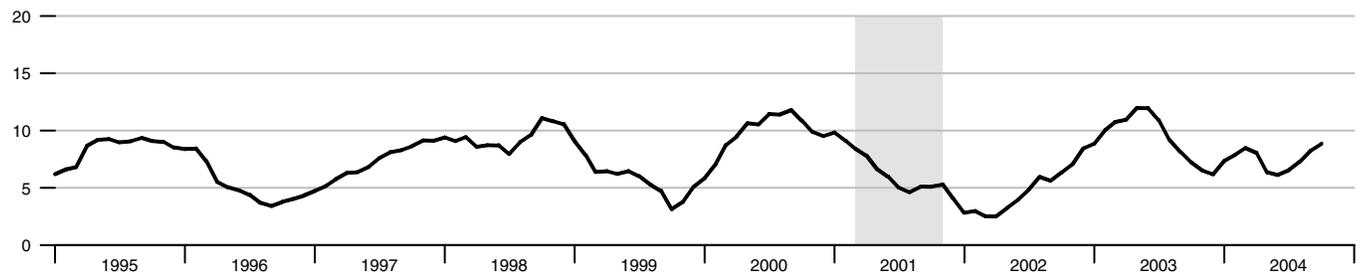
Percent change from year ago



Dashed lines indicate 10-year moving averages.

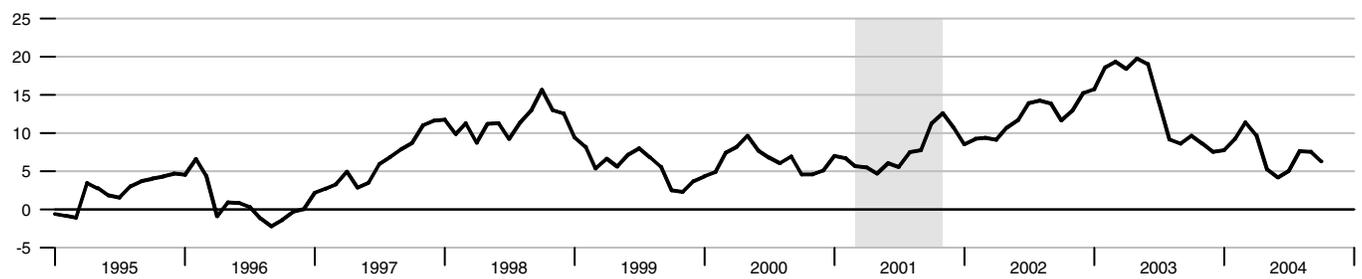
Bank Credit

Percent change from year ago



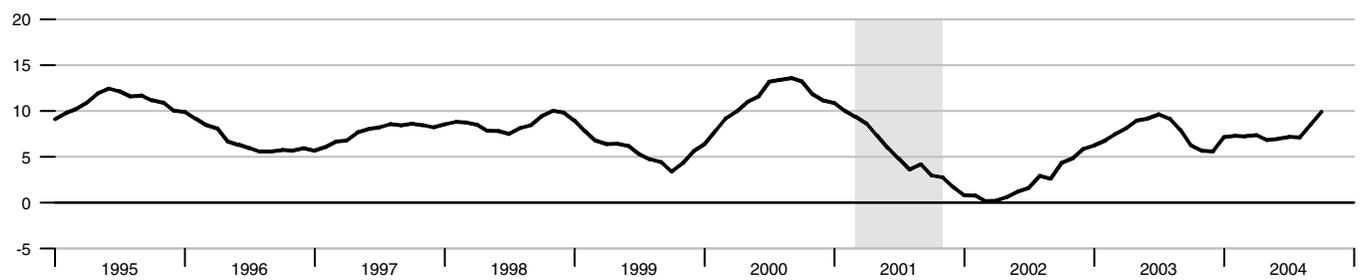
Investment Securities in Bank Credit at Commercial Banks

Percent change from year ago



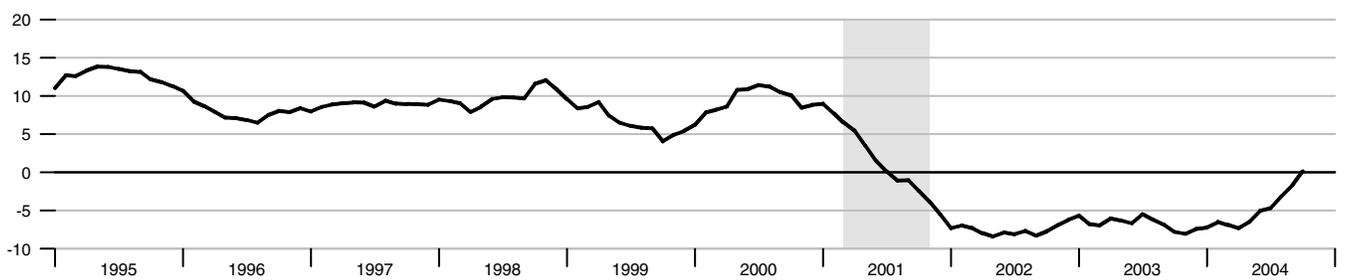
Total Loans and Leases in Bank Credit at Commercial Banks

Percent change from year ago

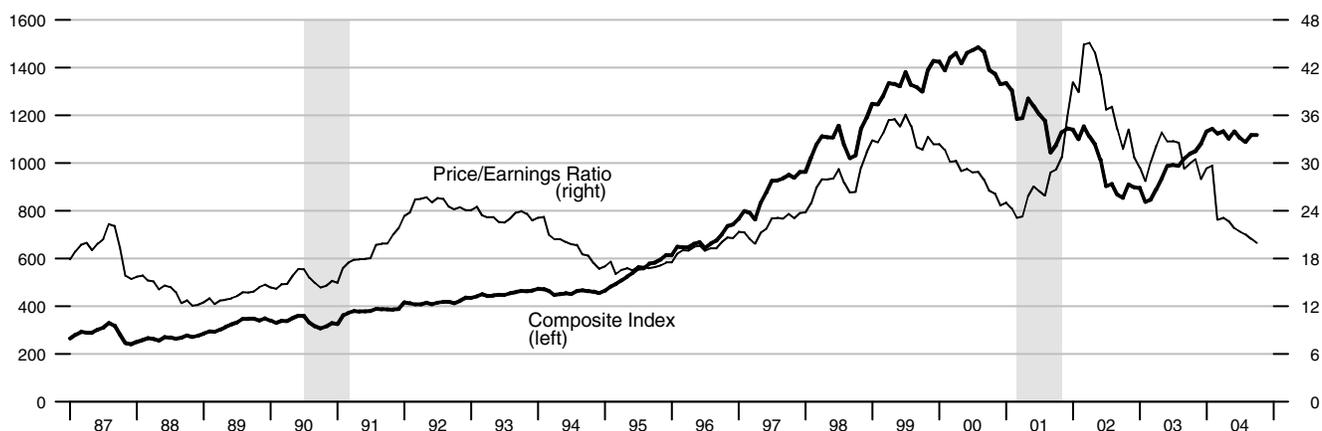


Commercial and Industrial Loans at Commercial Banks

Percent change from year ago



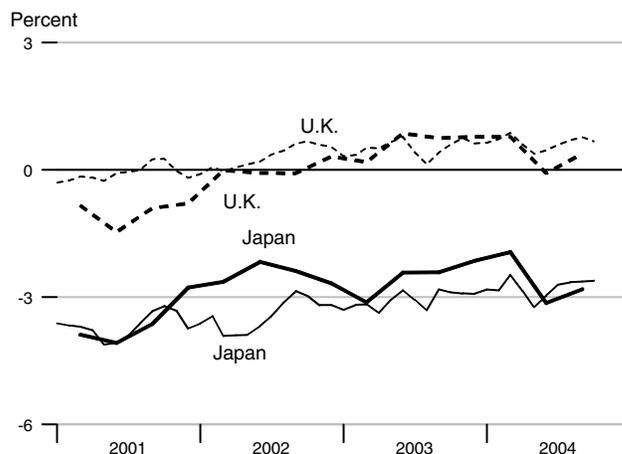
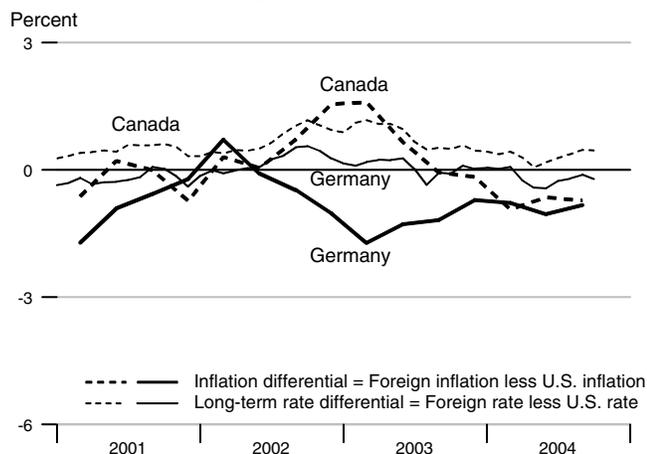
Standard & Poor's 500



Recent Inflation and Long-Term Interest Rates

| | Consumer Price Inflation Rates | | | | Long-Term Government Bond Rates | | | |
|----------------|--------------------------------|--------|--------|--------|---------------------------------|-------|-------|-------|
| | Percent change from year ago | | | | Percent | | | |
| | 2003Q4 | 2004Q1 | 2004Q2 | 2004Q3 | Jul04 | Aug04 | Sep04 | Oct04 |
| United States | 1.87 | 1.80 | 2.84 | 2.71 | 4.50 | 4.28 | 4.13 | 4.10 |
| Canada | 1.71 | 0.87 | 2.18 | 1.99 | 4.78 | 4.65 | 4.60 | 4.56 |
| France | 2.19 | 1.80 | 2.38 | 2.28 | 4.27 | 4.11 | 4.09 | . |
| Germany | 1.16 | 1.02 | 1.79 | 1.88 | 4.24 | 4.08 | 4.02 | 3.89 |
| Italy | 2.53 | 2.29 | 2.33 | 2.23 | 4.44 | 4.28 | 4.25 | 4.13 |
| Japan | -0.27 | -0.14 | -0.31 | -0.10 | 1.79 | 1.63 | 1.50 | 1.49 |
| United Kingdom | 2.65 | 2.58 | 2.75 | 3.09 | 5.09 | 4.98 | 4.90 | 4.77 |

Inflation and Long-Term Interest Rate Differentials



| | | Money Stock | | | | Bank Credit | Adjusted | | MSI M2 |
|------|-----|-------------|----------|----------|----------|----------------|---------------|----------|---------|
| | | M1 | MZM | M2 | M3 | | Monetary Base | Reserves | |
| 1999 | | 1101.461 | 4170.400 | 4525.990 | 6261.554 | 4577.659 | 574.181 | 88.664 | 229.389 |
| 2000 | | 1103.415 | 4508.945 | 4801.682 | 6852.007 | 5025.436 | 607.106 | 84.511 | 242.177 |
| 2001 | | 1136.880 | 5221.045 | 5219.653 | 7632.944 | 5345.437 | 641.167 | 85.923 | 263.729 |
| 2002 | | 1191.998 | 5891.326 | 5614.803 | 8244.826 | 5597.301 | 697.072 | 87.914 | 285.723 |
| 2003 | | 1263.997 | 6322.064 | 5998.586 | 8761.179 | 6120.519 | 740.674 | 92.828 | 305.770 |
| 2002 | 1 | 1186.889 | 5741.673 | 5499.716 | 8082.087 | 5420.075 | 680.264 | 88.149 | 279.213 |
| | 2 | 1184.073 | 5828.690 | 5549.617 | 8161.282 | 5496.265 | 692.937 | 86.970 | 282.329 |
| | 3 | 1189.213 | 5927.543 | 5648.402 | 8275.904 | 5655.519 | 702.753 | 86.805 | 287.729 |
| | 4 | 1207.817 | 6067.399 | 5761.477 | 8460.032 | 5817.344 | 712.332 | 89.733 | 293.619 |
| 2003 | 1 | 1232.004 | 6187.293 | 5861.339 | 8599.997 | 5955.926 | 726.828 | 90.856 | 298.747 |
| | 2 | 1258.261 | 6282.236 | 5981.702 | 8723.389 | 6136.149 | 738.230 | 91.757 | 304.838 |
| | 3 | 1278.765 | 6433.579 | 6085.531 | 8872.374 | 6186.738 | 743.993 | 94.581 | 310.160 |
| | 4 | 1286.957 | 6385.149 | 6065.773 | 8848.955 | 6203.262 | 753.644 | 94.119 | 309.336 |
| 2004 | 1 | 1306.895 | 6425.988 | 6119.429 | 8983.926 | 6426.606 | 761.085 | 94.363 | 312.257 |
| | 2 | 1327.274 | 6594.018 | 6268.531 | 9225.381 | 6556.289 | 770.821 | 96.014 | 319.999 |
| | 3 | 1336.550 | 6609.271 | 6307.677 | 9282.897 | 6641.803 | 782.543 | 96.269 | 322.227 |
| 2002 | Oct | 1201.818 | 5969.836 | 5722.696 | 8348.287 | 5747.294 | 710.666 | 89.805 | 291.621 |
| | Nov | 1204.472 | 6084.499 | 5767.200 | 8479.398 | 5818.978 | 712.475 | 89.818 | 293.937 |
| | Dec | 1217.161 | 6147.863 | 5794.536 | 8552.410 | 5885.759 | 713.854 | 89.575 | 295.299 |
| 2003 | Jan | 1220.382 | 6159.131 | 5825.525 | 8564.760 | 5888.802 | 719.531 | 89.449 | 296.929 |
| | Feb | 1235.054 | 6192.703 | 5867.344 | 8601.856 | 5970.305 | 728.668 | 91.828 | 299.044 |
| | Mar | 1240.575 | 6210.044 | 5891.147 | 8633.374 | 6008.671 | 732.286 | 91.291 | 300.268 |
| | Apr | 1246.093 | 6241.488 | 5933.849 | 8670.375 | 6048.932 | 736.491 | 92.283 | 302.429 |
| | May | 1257.661 | 6277.882 | 5985.144 | 8725.214 | 6153.042 | 738.664 | 91.428 | 305.002 |
| | Jun | 1271.030 | 6327.337 | 6026.113 | 8774.577 | 6206.474 | 739.536 | 91.559 | 307.082 |
| | Jul | 1273.435 | 6417.229 | 6066.128 | 8848.971 | 6194.841 | 741.241 | 93.485 | 309.153 |
| | Aug | 1281.496 | 6448.836 | 6106.591 | 8888.596 | 6180.050 | 745.242 | 95.383 | 311.207 |
| | Sep | 1281.363 | 6434.671 | 6083.873 | 8879.555 | 6185.323 | 745.496 | 94.876 | 310.121 |
| | Oct | 1284.074 | 6404.316 | 6069.055 | 8856.833 | 6161.765 | 753.680 | 95.231 | 309.422 |
| | Nov | 1283.390 | 6384.628 | 6065.799 | 8844.422 | 6198.260 | 754.634 | 94.768 | 309.369 |
| | Dec | 1293.407 | 6366.504 | 6062.465 | 8845.611 | 6249.761 | 752.618 | 92.359 | 309.217 |
| 2004 | Jan | 1287.453 | 6379.960 | 6070.139 | 8905.344 | 6321.002 | 756.452 | 92.550 | 309.808 |
| | Feb | 1306.954 | 6419.689 | 6120.266 | 8977.863 | 6440.957 | 762.848 | 95.239 | 312.308 |
| | Mar | 1326.279 | 6478.316 | 6167.882 | 9068.571 | 6517.858 | 763.956 | 95.299 | 314.655 |
| | Apr | 1323.478 | 6540.625 | 6216.864 | 9148.129 | 6536.665 | 767.619 | 96.485 | 317.266 |
| | May | 1322.552 | 6617.718 | 6289.642 | 9249.042 | 6544.825 | 769.877 | 95.187 | 321.127 |
| | Jun | 1335.793 | 6623.712 | 6299.086 | 9278.971 | 6587.378 | 774.968 | 96.369 | 321.604 |
| | Jul | 1324.030 | 6598.485 | 6292.024 | 9257.284 | 6600.417 | 780.297 | 95.251 | 321.500 |
| | Aug | 1341.100 | 6607.046 | 6300.753 | 9280.475 | 6629.386 | 781.300 | 95.502 | 321.837 |
| | Sep | 1344.521 | 6622.281 | 6330.254 | 9310.931 | 6695.606 | 786.032 | 98.054 | 323.345 |
| | Oct | 1343.661 | 6603.834 | 6342.637 | 9285.069 | 6707.425 | 791.916 | 96.963 | 324.180 |

*All values are given in billions of dollars.

| | Federal Funds | Discount Rate | Primary Credit Rate | Prime Rate | 3-mo CDs | Treasury Yields | | | Corporate Aaa Bonds | S & L Aaa Bonds | Conventional Mortgage | |
|------|------------------|------------------|------------------------|---------------|-------------|-----------------|------|-------|------------------------|--------------------|--------------------------|------|
| | | | | | | 3-mo | 3-yr | 10-yr | | | | |
| 1999 | 4.97 | 4.62 | | 7.99 | 5.33 | 4.78 | 5.49 | 5.64 | 7.04 | 5.28 | 7.43 | |
| 2000 | 6.24 | 5.73 | | 9.23 | 6.46 | 6.00 | 6.22 | 6.03 | 7.62 | 5.58 | 8.06 | |
| 2001 | 3.89 | 3.41 | | 6.92 | 3.69 | 3.47 | 4.08 | 5.02 | 7.08 | 5.01 | 6.97 | |
| 2002 | 1.67 | 1.17 | | 4.68 | 1.73 | 1.63 | 3.10 | 4.61 | 6.49 | 4.87 | 6.54 | |
| 2003 | 1.13 | | 2.11 | 4.12 | 1.15 | 1.03 | 2.11 | 4.02 | 5.67 | 4.52 | 5.82 | |
| 2002 | 1 | 1.73 | 1.25 | 4.75 | 1.82 | 1.76 | 3.75 | 5.08 | 6.62 | 5.02 | 6.97 | |
| | 2 | 1.75 | 1.25 | 4.75 | 1.83 | 1.75 | 3.77 | 5.10 | 6.71 | 5.01 | 6.81 | |
| | 3 | 1.74 | 1.25 | 4.75 | 1.76 | 1.67 | 2.62 | 4.26 | 6.35 | 4.72 | 6.29 | |
| | 4 | 1.44 | 0.94 | 4.45 | 1.49 | 1.36 | 2.27 | 4.01 | 6.28 | 4.71 | 6.08 | |
| 2003 | 1 | 1.25 | | 2.25 | 4.25 | 1.26 | 1.18 | 2.07 | 3.92 | 6.00 | 4.60 | 5.83 |
| | 2 | 1.25 | | 2.23 | 4.24 | 1.17 | 1.06 | 1.77 | 3.62 | 5.31 | 4.28 | 5.51 |
| | 3 | 1.02 | | 2.00 | 4.00 | 1.07 | 0.95 | 2.20 | 4.23 | 5.70 | 4.68 | 6.01 |
| | 4 | 1.00 | | 2.00 | 4.00 | 1.10 | 0.93 | 2.38 | 4.29 | 5.66 | 4.52 | 5.92 |
| 2004 | 1 | 1.00 | | 2.00 | 4.00 | 1.05 | 0.93 | 2.17 | 4.02 | 5.45 | 4.26 | 5.60 |
| | 2 | 1.01 | | 2.00 | 4.00 | 1.25 | 1.10 | 2.98 | 4.60 | 5.93 | 4.82 | 6.13 |
| | 3 | 1.43 | | 2.42 | 4.42 | 1.70 | 1.51 | 2.92 | 4.30 | 5.64 | 4.54 | 5.89 |
| 2002 | Oct | 1.75 | 1.25 | 4.75 | 1.73 | 1.61 | 2.25 | 3.94 | 6.32 | 4.66 | 6.11 | |
| | Nov | 1.34 | 0.83 | 4.35 | 1.39 | 1.25 | 2.32 | 4.05 | 6.31 | 4.77 | 6.07 | |
| | Dec | 1.24 | 0.75 | 4.25 | 1.34 | 1.21 | 2.23 | 4.03 | 6.21 | 4.70 | 6.05 | |
| 2003 | Jan | 1.24 | | 4.25 | 1.29 | 1.19 | 2.18 | 4.05 | 6.17 | 4.72 | 5.92 | |
| | Feb | 1.26 | | 2.25 | 4.25 | 1.27 | 1.19 | 2.05 | 3.90 | 5.95 | 4.57 | 5.84 |
| | Mar | 1.25 | | 2.25 | 4.25 | 1.23 | 1.15 | 1.98 | 3.81 | 5.89 | 4.51 | 5.75 |
| | Apr | 1.26 | | 2.25 | 4.25 | 1.24 | 1.15 | 2.06 | 3.96 | 5.74 | 4.60 | 5.81 |
| | May | 1.26 | | 2.25 | 4.25 | 1.22 | 1.09 | 1.75 | 3.57 | 5.22 | 4.16 | 5.48 |
| | Jun | 1.22 | | 2.20 | 4.22 | 1.04 | 0.94 | 1.51 | 3.33 | 4.97 | 4.07 | 5.23 |
| | Jul | 1.01 | | 2.00 | 4.00 | 1.05 | 0.92 | 1.93 | 3.98 | 5.49 | 4.59 | 5.63 |
| | Aug | 1.03 | | 2.00 | 4.00 | 1.08 | 0.97 | 2.44 | 4.45 | 5.88 | 4.82 | 6.26 |
| | Sep | 1.01 | | 2.00 | 4.00 | 1.08 | 0.96 | 2.23 | 4.27 | 5.72 | 4.63 | 6.15 |
| | Oct | 1.01 | | 2.00 | 4.00 | 1.10 | 0.94 | 2.26 | 4.29 | 5.70 | 4.64 | 5.95 |
| | Nov | 1.00 | | 2.00 | 4.00 | 1.11 | 0.95 | 2.45 | 4.30 | 5.65 | 4.50 | 5.93 |
| | Dec | 0.98 | | 2.00 | 4.00 | 1.10 | 0.91 | 2.44 | 4.27 | 5.62 | 4.41 | 5.88 |
| 2004 | Jan | 1.00 | | 2.00 | 4.00 | 1.06 | 0.90 | 2.27 | 4.15 | 5.54 | 4.42 | 5.71 |
| | Feb | 1.01 | | 2.00 | 4.00 | 1.05 | 0.94 | 2.25 | 4.08 | 5.50 | 4.26 | 5.64 |
| | Mar | 1.00 | | 2.00 | 4.00 | 1.05 | 0.95 | 2.00 | 3.83 | 5.33 | 4.11 | 5.45 |
| | Apr | 1.00 | | 2.00 | 4.00 | 1.08 | 0.96 | 2.57 | 4.35 | 5.73 | 4.69 | 5.83 |
| | May | 1.00 | | 2.00 | 4.00 | 1.20 | 1.04 | 3.10 | 4.72 | 6.04 | 4.93 | 6.27 |
| | Jun | 1.03 | | 2.01 | 4.01 | 1.46 | 1.29 | 3.26 | 4.73 | 6.01 | 4.85 | 6.29 |
| | Jul | 1.26 | | 2.25 | 4.25 | 1.57 | 1.36 | 3.05 | 4.50 | 5.82 | 4.71 | 6.06 |
| | Aug | 1.43 | | 2.43 | 4.43 | 1.68 | 1.50 | 2.88 | 4.28 | 5.65 | 4.52 | 5.87 |
| | Sep | 1.61 | | 2.58 | 4.58 | 1.86 | 1.68 | 2.83 | 4.13 | 5.46 | 4.40 | 5.75 |
| | Oct | 1.76 | | 2.75 | 4.75 | 2.04 | 1.79 | 2.85 | 4.10 | 5.47 | 4.38 | 5.72 |

*All values are given as a percent at an annual rate.

| | | M1 | MZM | M2 | M3 |
|---|-----|--------|-------|-------|-------|
| Percent change at an annual rate | | | | | |
| 1999 | | 2.00 | 12.41 | 7.54 | 8.74 |
| 2000 | | 0.18 | 8.12 | 6.09 | 9.43 |
| 2001 | | 3.03 | 15.79 | 8.70 | 11.40 |
| 2002 | | 4.85 | 12.84 | 7.57 | 8.02 |
| 2003 | | 6.04 | 7.31 | 6.84 | 6.26 |
| <hr/> | | | | | |
| 2002 | 1 | 5.94 | 11.13 | 7.35 | 6.54 |
| | 2 | -0.95 | 6.06 | 3.63 | 3.92 |
| | 3 | 1.74 | 6.78 | 7.12 | 5.62 |
| | 4 | 6.26 | 9.44 | 8.01 | 8.90 |
| 2003 | 1 | 8.01 | 7.90 | 6.93 | 6.62 |
| | 2 | 8.53 | 6.14 | 8.21 | 5.74 |
| | 3 | 6.52 | 9.64 | 6.94 | 6.83 |
| | 4 | 2.56 | -3.01 | -1.30 | -1.06 |
| 2004 | 1 | 6.20 | 2.56 | 3.54 | 6.10 |
| | 2 | 6.24 | 10.46 | 9.75 | 10.75 |
| | 3 | 2.80 | 0.93 | 2.50 | 2.49 |
| <hr/> | | | | | |
| 2002 | Oct | 11.38 | 3.43 | 9.47 | 3.89 |
| | Nov | 2.65 | 23.05 | 9.33 | 18.85 |
| | Dec | 12.64 | 12.50 | 5.69 | 10.33 |
| 2003 | Jan | 3.18 | 2.20 | 6.42 | 1.73 |
| | Feb | 14.43 | 6.54 | 8.61 | 5.20 |
| | Mar | 5.36 | 3.36 | 4.87 | 4.40 |
| | Apr | 5.34 | 6.08 | 8.70 | 5.14 |
| | May | 11.14 | 7.00 | 10.37 | 7.59 |
| | Jun | 12.76 | 9.45 | 8.21 | 6.79 |
| | Jul | 2.27 | 17.05 | 7.97 | 10.17 |
| | Aug | 7.60 | 5.91 | 8.00 | 5.37 |
| | Sep | -0.12 | -2.64 | -4.46 | -1.22 |
| | Oct | 2.54 | -5.66 | -2.92 | -3.07 |
| | Nov | -0.64 | -3.69 | -0.64 | -1.68 |
| | Dec | 9.37 | -3.41 | -0.66 | 0.16 |
| 2004 | Jan | -5.52 | 2.54 | 1.52 | 8.10 |
| | Feb | 18.18 | 7.47 | 9.91 | 9.77 |
| | Mar | 17.74 | 10.96 | 9.34 | 12.12 |
| | Apr | -2.53 | 11.54 | 9.53 | 10.53 |
| | May | -0.84 | 14.14 | 14.05 | 13.24 |
| | Jun | 12.01 | 1.09 | 1.80 | 3.88 |
| | Jul | -10.57 | -4.57 | -1.35 | -2.80 |
| | Aug | 15.47 | 1.56 | 1.66 | 3.01 |
| | Sep | 3.06 | 2.77 | 5.62 | 3.94 |
| | Oct | -0.77 | -3.34 | 2.35 | -3.33 |

Definitions

M1: The sum of currency held outside the vaults of depository institutions, Federal Reserve Banks, and the U.S. Treasury; travelers checks; and demand and other checkable deposits issued by financial institutions (except demand deposits due to the Treasury and depository institutions), minus cash items in process of collection and Federal Reserve float.

MZM (money, zero maturity): M2 minus small-denomination time deposits, plus institutional money market mutual funds (that is, those included in M3 but excluded from M2). The label MZM was coined by William Poole (1991); the aggregate itself was proposed earlier by Motley (1988).

M2: M1 plus savings deposits (including money market deposit accounts) and small-denomination (under \$100,000) time deposits issued by financial institutions; and shares in retail money market mutual funds (funds with initial investments under \$50,000), net of retirement accounts.

M3: M2 plus large-denomination (\$100,000 or more) time deposits; repurchase agreements issued by depository institutions; Eurodollar deposits, specifically, dollar-denominated deposits due to nonbank U.S. addresses held at foreign offices of U.S. banks worldwide and all banking offices in Canada and the United Kingdom; and institutional money market mutual funds (funds with initial investments of \$50,000 or more).

Bank Credit: All loans, leases, and securities held by commercial banks.

Domestic Nonfinancial Debt: Total credit market liabilities of the U.S. Treasury, federally sponsored agencies, state and local governments, households, and nonfinancial firms. End-of-period basis.

Adjusted Monetary Base: The sum of currency in circulation outside Federal Reserve Banks and the U.S. Treasury, deposits of depository financial institutions at Federal Reserve Banks, and an adjustment for the effects of changes in statutory reserve requirements on the quantity of base money held by depositories. This series is a spliced chain index; see Anderson and Rasche (1996a,b, 2001, 2003).

Adjusted Reserves: The sum of vault cash and Federal Reserve Bank deposits held by depository institutions and an adjustment for the effects of changes in statutory reserve requirements on the quantity of base money held by depositories. This spliced chain index is numerically larger than the Board of Governors' measure, which excludes vault cash not used to satisfy statutory reserve requirements and Federal Reserve Bank deposits used to satisfy required clearing balance contracts; see Anderson and Rasche (1996a, 2001, 2003).

Monetary Services Index: An index that measures the flow of monetary services received by households and firms from their holdings of liquid assets; see Anderson, Jones, and Nesmith (1997). Indexes are shown for the assets included in M2, with additional data at research.stlouisfed.org/msi/index.html.

Note: M1, M2, M3, Bank Credit, and Domestic Nonfinancial Debt are constructed and published by the Board of Governors of the Federal Reserve System. For details, see *Statistical Supplement to the Federal Reserve Bulletin*, tables 1.21 and 1.26. MZM, Adjusted Monetary Base, Adjusted Reserves, and Monetary Services Index are constructed and published by the Research Division of the Federal Reserve Bank of St. Louis.

Notes

Page 3: Readers are cautioned that, since early 1994, the level and growth of M1 have been depressed by retail sweep programs that reclassify transactions deposits (demand deposits and other checkable deposits) as savings deposits overnight, thereby reducing banks' required reserves; see Anderson and Rasche (2001) and research.stlouisfed.org/aggreg/swdata.html. **Primary Credit Rate**, **Discount Rate**, and **Intended Federal Funds Rate** shown in the chart **Reserve Market Rates** are plotted as of the date of the change, while the **Effective Federal Funds Rate** is plotted as of the end of the month. Interest rates in the table are monthly averages from the Board of Governors H.15 Statistical Release. The **Treasury Yield Curve** shows constant maturity yields calculated by the U.S. Treasury for securities with 3 months and 1, 2, 3, 5, 7, and 10 years to maturity. Daily data and descriptions are available at research.stlouisfed.org/fred2/. See

also *Statistical Supplement to the Federal Reserve Bulletin*, table 1.35. The 30-year constant maturity series was discontinued by the Treasury as of February 18, 2002.

Page 5: **Checkable Deposits** is the sum of demand and other checkable deposits. **Savings Deposits** is the sum of money market deposit accounts and passbook and statement savings. **Time Deposits** have a minimum initial maturity of 7 days. **Large Time Deposits** are deposits of \$100,000 or more. **Retail and Institutional Money Market Mutual Funds** are as included in M2 and the non-M2 component of M3, respectively.

Page 7: **Excess Reserves plus RCB (Required Clearing Balance) Contracts** equals the amount of deposits at Federal Reserve Banks held by depository institutions but not applied to satisfy statutory reserve requirements. (This measure excludes the vault cash held by depository institutions that is not applied to satisfy statutory reserve requirements.) **Consumer Credit** includes most short- and intermediate-term credit extended to individuals. See *Statistical Supplement to the Federal Reserve Bulletin*, table 1.55.

Page 8: **Inflation Expectations** measures include the quarterly Federal Reserve Bank of Philadelphia *Survey of Professional Forecasters*, the monthly University of Michigan Survey Research Center's *Surveys of Consumers*, and the annual Federal Open Market Committee (FOMC) range as reported to the Congress in the February testimony that accompanies the Monetary Policy Report to the Congress. Beginning February 2000, the FOMC began using the personal consumption expenditures (PCE) price index to report its inflation range; the FOMC then switched to the PCE chain-type price index excluding food and energy prices ("core") beginning July 2004. Accordingly, neither are shown on this graph. **CPI Inflation** is the percentage change from a year ago in the consumer price index for all urban consumers. **Real Interest Rates** are ex post measures, equal to nominal rates minus CPI inflation.

Page 9: **FOMC Intended Federal Funds Rate** is the level (or midpoint of the range, if applicable) of the federal funds rate that the staff of the FOMC expected to be consistent with the desired degree of pressure on bank reserve positions. In recent years, the FOMC has set an explicit target for the federal funds rate.

Page 10: **Federal Funds Rate and Inflation Targets** shows the observed federal funds rate, quarterly, and the level of the funds rate implied by applying Taylor's (1993) equation

$$f_t^* = 2.5 + \pi_{t-1} + (\pi_{t-1} - \pi^*)/2 + 100 \times (y_{t-1} - y_{t-1}^P)/2$$

to five alternative target inflation rates, $\pi^* = 0, 1, 2, 3, 4$ percent, where f_t^* is the implied federal funds rate, π_{t-1} is the previous period's inflation rate (PCE) measured on a year-over-year basis, y_{t-1} is the log of the previous period's level of real gross domestic product (GDP), and y_{t-1}^P is the log of an estimate of the previous period's level of potential output. **Potential Real GDP** is as estimated by the Congressional Budget Office.

Monetary Base Growth and Inflation Targets shows the quarterly growth of the adjusted monetary base (modified to include an estimate of the effect of sweep programs) implied by applying McCallum's (1988, 1993) equation

$$\Delta MB_t^* = \pi^* + (10\text{-year moving average growth of real GDP}) - (4\text{-year moving average of base velocity growth})$$

to five alternative target inflation rates, $\pi^* = 0, 1, 2, 3, 4$ percent, where ΔMB_t^* is the implied growth rate of the adjusted monetary base. The 10-year moving average growth of real GDP for a quarter t is calculated as the average quarterly growth during the previous 40 quarters, at an annual rate, by the formula $((y_t - y_{t-40})/40) \times 400$, where y_t is the log of real GDP. The 4-year moving average of base velocity growth is calculated similarly. To adjust the monetary base for the effect of retail-deposit sweep programs, we add to the monetary base an amount equal to 10 percent of the total amount swept, as estimated by the Federal Reserve Board staff. These estimates are imprecise, at best. Sweep program data are found at research.stlouisfed.org/aggreg/swdata.html.

Page 11: **Implied One-Year Forward Rates** are calculated by this Bank from Treasury constant maturity yields. Yields to maturity, $R(m)$, for securities with $m = 1, \dots, 10$ years to maturity are obtained by linear interpolation between

reported yields. These yields are smoothed by fitting the regression suggested by Nelson and Siegel (1987),

$$R(m) = a_0 + (a_1 + a_2)(1 - e^{-m/50})/(m/50) - a_2 \times e^{-m/50},$$

and forward rates are calculated from these smoothed yields using equation (a) in table 13.1 of Shiller (1990),

$$f(m) = [D(m)R(m) - D(m-1)] / [D(m) - D(m-1)],$$

where duration is approximated as $D(m) = (1 - e^{-R(m) \times m})/R(m)$. These rates are linear approximations to the true instantaneous forward rates; see Shiller (1990). For a discussion of the use of forward rates as indicators of inflation expectations, see Sharpe (1997). **Rates on 3-Month Eurodollar Futures** and **Rates on Selected Federal Funds Futures Contracts** trace through time the yield on three specific contracts. **Rates on Federal Funds Futures on Selected Dates** displays a single day's snapshot of yields for contracts expiring in the months shown on the horizontal axis. **Inflation-Indexed Treasury Securities** are yields on the most recently issued inflation-indexed securities of 10- and 30-year original maturities. **Inflation-Indexed 10-Year Government Notes** shows the yield of an inflation-indexed note that is scheduled to mature in approximately (but not greater than) 10 years. The current French note has a maturity date of 7/25/2013, the current U.K. note has a maturity date of 8/16/2013, and the current U.S. note has a maturity date of 7/15/2014. **Inflation-Indexed Treasury Yield Spreads** and **Inflation-Indexed 10-Year Government Yield Spreads** equal the difference between the yields on the most recently issued inflation-indexed securities and the unadjusted security yields of similar maturity.

Page 12: Velocity (for MZM and M2) equals the ratio of GDP, measured in current dollars, to the level of the monetary aggregate. **MZM and M2 Own Rates** are weighted averages of the rates received by households and firms on the assets included in the aggregates. Prior to 1982, the 3-month T-bill rates are secondary market yields. From 1982 forward, rates are 3-month constant maturity yields.

Page 13: Real Gross Domestic Product is GDP as measured in chained 2000 dollars. The **Gross Domestic Product Price Index** is the implicit price deflator for GDP, which is defined by the Bureau of Economic Analysis, U.S. Department of Commerce, as the ratio of GDP measured in current dollars to GDP measured in chained 2000 dollars.

Page 14: Investment Securities are all securities held by commercial banks in both investment and trading accounts.

Page 15: Inflation Rate Differentials are the differences between the foreign consumer price inflation rates and year-over-year changes in the U.S. all-items Consumer Price Index.

Page 17: Treasury Yields are Treasury constant maturities as reported in the Board of Governors of the Federal Reserve System's H.15 release.

Sources

Agence France Trésor: French note yields.

Bank of Canada: Canadian note yields.

Bank of England: U.K. note yields.

Board of Governors of the Federal Reserve System:

Monetary aggregates and components: H.6 release. Bank credit and components: H.8 release. Consumer credit: G.19 release. Required reserves, excess reserves, clearing balance contracts, and discount window borrowing: H.4.1 and H.3 releases. Interest rates: H.15 release. Nonfinancial commercial paper: Board of Governors website. Nonfinancial debt: Z.1 release. M2 own rate.

Bureau of Economic Analysis: GDP.

Bureau of Labor Statistics: CPI.

Chicago Board of Trade: Federal funds futures contract.

Chicago Mercantile Exchange: Eurodollar futures.

Congressional Budget Office: Potential real GDP.

Federal Reserve Bank of Philadelphia: Survey of Professional Forecasters inflation expectations.

Federal Reserve Bank of St. Louis: Adjusted monetary base and adjusted reserves, monetary services index, MZM own rate, one-year forward rates.

Organization for Economic Cooperation and Development: International interest and inflation rates.

Standard & Poor's: Stock price-earnings ratio, stock price composite index.

University of Michigan Survey Research Center: Median expected price change.

U.S. Department of the Treasury: U.S. security yields.

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Anderson, Richard G. and Robert H. Rasche (1996a). "A Revised Measure of the St. Louis Adjusted Monetary Base," *Federal Reserve Bank of St. Louis Review*, March/April, 78(2), pp. 3-13.*

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Note: *Available on the Internet at research.stlouisfed.org/publications/review/.