



Interpreting Monetary Growth

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As the economy slipped into recession last year, the FOMC reduced its target level for the overnight federal funds rate by 475 basis points to 1.75 percent. Also during the year, growth of the monetary aggregates jumped sharply. Fourth quarter to fourth quarter, M2 and MZM increased approximately 10 and 20 percent, respectively. M2's growth was two-thirds more than its average during the previous two years and MZM's more than twice its average. Such rapid growth has led some analysts to express concern that the past two decades' progress toward low, stable inflation may be at risk.

Last year's increase in money growth was largely consistent with historical money-demand behavior. During the year, both the aggregates' opportunity costs and velocities fell sharply (see page 12). Aside from changes in interest rates and opportunity costs, special factors such as the September 11 attacks likely played little, if any, role in the acceleration. Further, the composition of the aggregates shifted toward liquidity, in the past a harbinger of planned spending. Currency plus checkable and savings deposits accounted for all of the growth in M2 and approximately half the growth in MZM. Within M2, small-denomination time deposits decreased. This, also, was not surprising. The demand for time deposits is sensitive to their opportunity costs, that is, to current and expected future differentials between deposit rates and yields on other investments. Many investors perhaps were reluctant to enter into time deposits, expecting that a near-term rebound in economic activity would spur sluggish bank lending and lead to higher offering rates. At the same time, strong inflows of liquid deposits and robust sales of large CDs to money market mutual funds likely tempered banks' offering rates.

A surge in institutional-type money market mutual funds accounted for half the growth of MZM. It seems doubtful, however, that these flows have any macro-

economic significance. Due to their accounting practices, changes in the yields on institutional-type money market mutual funds tend to lag changes in available yields on market instruments. In particular, inflows to these funds may increase sharply when market yields fall quickly. Because of this lag, it seems likely that a significant part of last year's inflows will exit the funds later this year as market yields stabilize and, perhaps, increase. Nevertheless, even absent the inflows to institutional-type funds, MZM's growth exceeded 10 percent last year.

Sustained money growth at 10 percent per year is not consistent with long-run price stability. To avoid an acceleration of inflation, money growth must be slowed promptly as the economy rebounds. Recent empirical studies suggest that FOMC policy actions during the last two decades may be well approximated by a Taylor-type rule with interest rate smoothing where the smoothing reflects, in part, uncertainty regarding the behavior of the economy. Even though the growth of monetary aggregates has no current, formal near-term policymaking role, last year's rapid money growth suggests that the FOMC must be on guard against waiting too long to remove the punchbowl at this year's economic recovery party. ■

	Growth rate, 2000:Q4 to 2001:Q4 (percent annual rate)	Contribution to growth of (percentage points)	
		M2	MZM
M2	10.2		
MZM	20.4		
Currency	9.0	1.0	0.9
Saving and checkable deposits	17.8	9.0	8.8
Small-denomination time deposits	-6.8	-1.3	—
Retail-type money market mutual funds	8.4	1.5	1.5
Institution-type money market mutual funds	50.5	—	9.1

Views expressed do not necessarily reflect official positions of the Federal Reserve System.