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The U.K.'s Rocky Road to Stability

At the end of 2004, the United Kingdom will have had positive economic growth for 50 consecutive quarters, a record unmatched in its half-century of quarterly GDP data. Over those 50 quarters, inflation has been steady, averaging around 2.5 percent. These achievements represent the culmination of major overhaul of the U.K. economic policy framework over the past 25 years.

By the mid-1970s, the U.K. had drifted away from allowing markets to allocate resources. The public sector, which had taken over several major industries in the 1940s, extended its ownership of companies in the 1970s. Government spending hovered near 50 percent of GDP. The growth of the public sector was accompanied by onerous regulations and taxes on private-sector activity. Although U.K. membership in the European Union (since 1973) exposed firms to greater competition, further benefits of membership for U.K. residents were stifled by foreign exchange controls that made travel and investment overseas prohibitive. On taxes, Joseph Pechman observed: "The 1978-79 top-bracket rate of 83 percent on earned income was close to the highest in the world; the top rate of 98 percent on investment income was surpassed only in Algeria..."¹

Price stability was a casualty of postwar U.K. policies. Inflation averaged 13.4 percent in the 1970s and peaked at over 25 percent in 1975. This failure reflected the attachment by policymakers to nonmonetary views of inflation and their consequent reliance on wage/price controls instead of monetary policy to handle inflation.²

The postwar pattern of U.K. policymaking came to be summarized as "stop-go"—a phrase that reflects the economic instability that occurred, but falsely implies major policy changes. In fact, policy differences between successive administrations were minor; instability occurred because the consensus policies themselves were destabilizing.

The Thatcher government, elected in 1979, quickly abolished foreign exchange controls and the highest marginal tax rates, and more gradually implemented reform of the labor market and privatization. These reforms seem to have helped reverse some of the decline in the U.K.'s

productivity growth after 1973. Another fundamental change was the rejection of price controls in favor of a strict monetary policy for fighting inflation, which brought inflation down to an average of 5.1 percent in the decade after 1982. On government expenditure, Thatcher's contribution was not lower spending but, instead, sustaining the reduction in the ratio of government outlays to GDP achieved by the prior (Callaghan) administration. In her second term, Thatcher lost interest in macroeconomic policy and permitted the Treasury to reinstate a policy of fixed exchange rates. The subsequent boom and monetary tightening meant that when Thatcher left office in 1990, inflation was near double digits while unemployment and the government spending/GDP ratio were climbing again.

The more durable period of growth alongside low inflation followed the resumption of floating exchange rates and the introduction of inflation targeting in 1992, which was reinforced by the independence conferred on the Bank of England in 1997. Monetary policy deliberations have been promptly disclosed to the public since 1994 and since mid-1997 have consisted of monthly minutes of the Bank of England's Monetary Policy Committee, the U.K. equivalent of the Federal Open Market Committee.

With control of inflation now institutionalized through inflation targeting, a principal economic concern for the U.K. is how fiscal and regulatory policies can stimulate productivity growth. After initial fiscal restraint, which in 1998 brought government spending and taxes simultaneously below 40 percent of GDP for the first time in decades, the Blair government launched major expenditure programs that have so far produced higher prices for government output but little apparent increase in output volumes. The government will need to ensure that its recently extended command over resources does not hamper private-sector productivity. The U.K. will also need to use its membership in the European Union to encourage a regulatory environment that is favorable for growth.

—Edward Nelson

¹ Pechman, Joseph A. "Taxation," in R.E. Caves and L.B. Krause, eds., *Britain's Economic Performance*. Washington, DC: Brookings, 1980, pp. 199-253.

² See Nelson, Edward. "The Great Inflation of the Seventies: What Really Happened?" Federal Reserve Bank of St. Louis Working Paper 2004-001; and Nelson, Edward, and Nikolov, Kalin. "Monetary Policy and Stagflation in the U.K." *Journal of Money, Credit, and Banking*, June 2004, pp. 293-318.

Contents

Page

3	Monetary and Financial Indicators at a Glance
4	Monetary Aggregates and Their Components
6	Monetary Aggregates: Monthly Growth
7	Reserves Markets and Short-Term Credit Flows
8	Measures of Expected Inflation
9	Interest Rates
10	Policy-Based Inflation Indicators
11	Implied Forward Rates, Futures Contracts, and Inflation-Indexed Securities
12	Velocity, Gross Domestic Product, and M2
14	Bank Credit
15	Stock Market Index and Foreign Inflation and Interest Rates
16	Reference Tables
18	Definitions, Notes, and Sources

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: $[(x_t/x_{t-12})-1] \times 100$.

We welcome your comments addressed to:

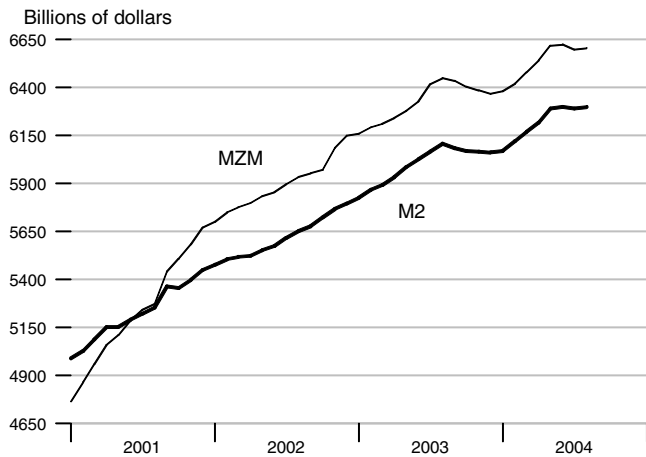
Editor, *Monetary Trends*
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St. Louis, MO 63166-0442

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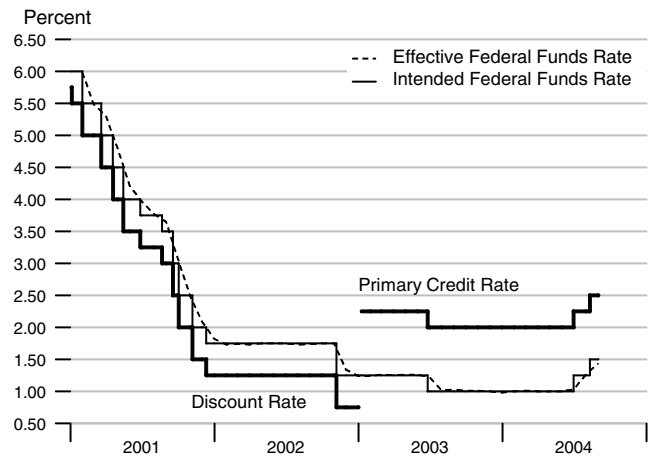
stlsFRED@stls.frb.org

Beginning this issue, the Monetary Services Index (MSI) as reported on pages 4 and 16 has undergone benchmark revisions. A working paper discussing this change is forthcoming. Please refer to research.stlouisfed.org/msi for other information regarding the MSI.

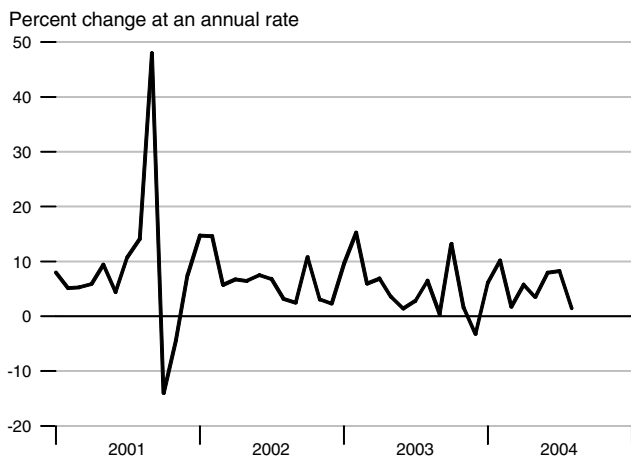
M2 and MZM



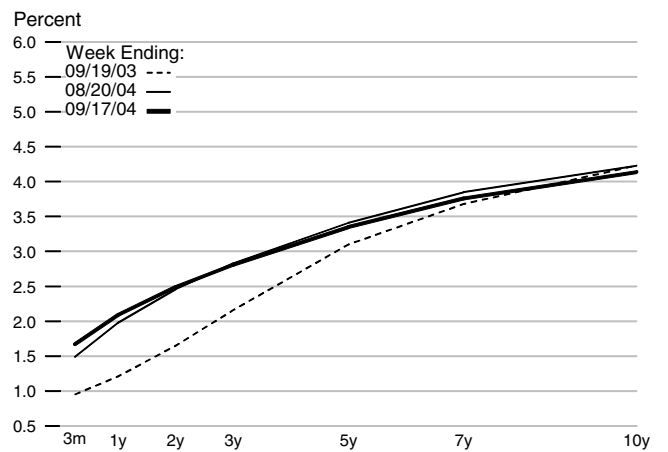
Reserve Market Rates



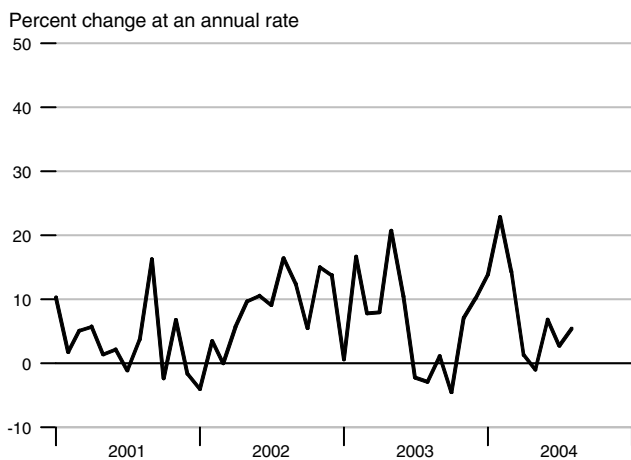
Adjusted Monetary Base



Treasury Yield Curve



Total Bank Credit

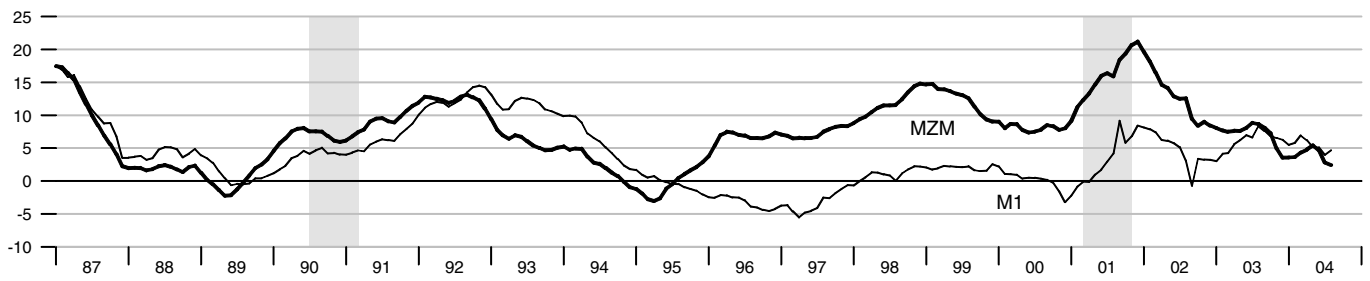


Interest Rates

	Jun 04	Jul 04	Aug 04
Federal Funds Rate	1.03	1.26	1.43
Prime Rate	4.00	4.25	4.42
Primary Credit Rate	2.01	2.25	2.43
Conventional Mortgage Rate	6.29	6.06	5.87
Treasury Yields:			
3-Month Constant Maturity	1.29	1.36	1.50
6-Month Constant Maturity	1.64	1.70	1.76
1-Year Constant Maturity	2.12	2.10	2.02
3-Year Constant Maturity	3.26	3.05	2.88
5-Year Constant Maturity	3.93	3.69	3.47
10-Year Constant Maturity	4.73	4.50	4.28

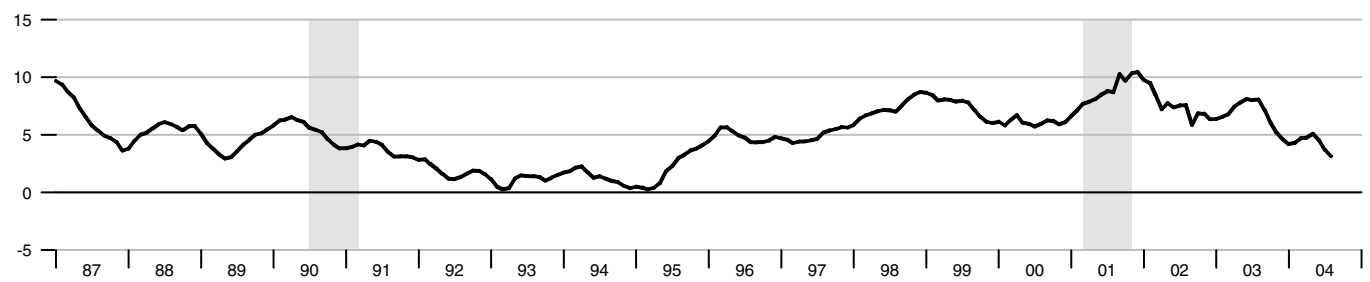
MZM and M1

Percent change from year ago



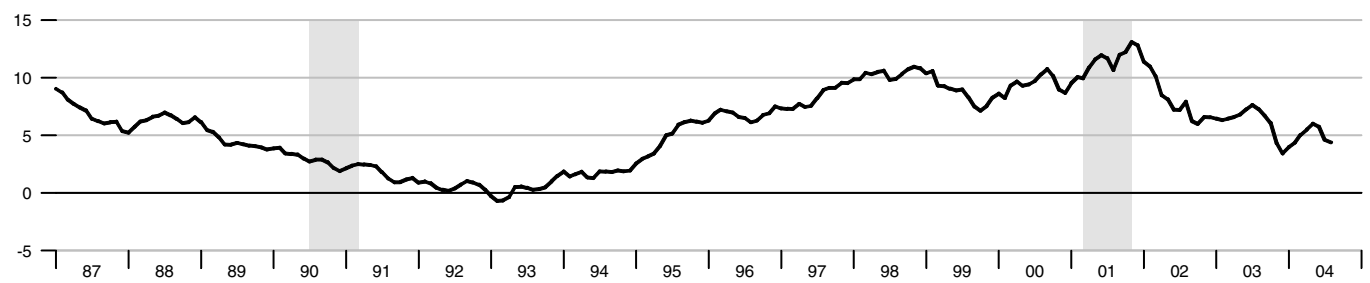
M2

Percent change from year ago



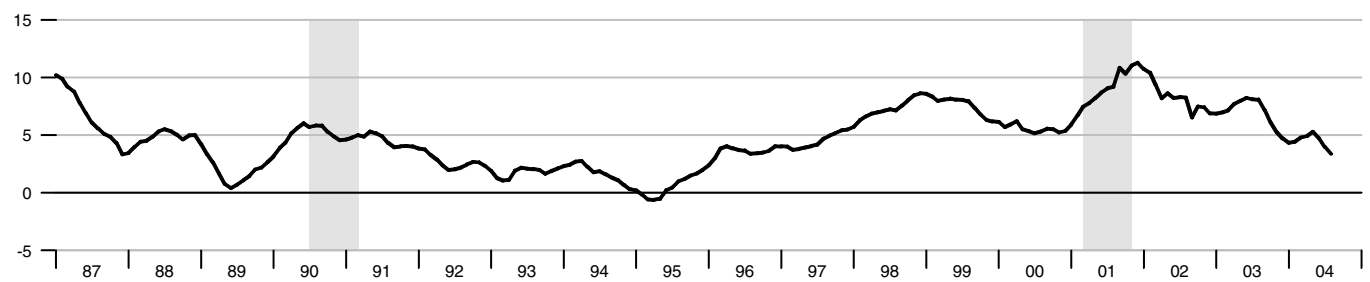
M3

Percent change from year ago



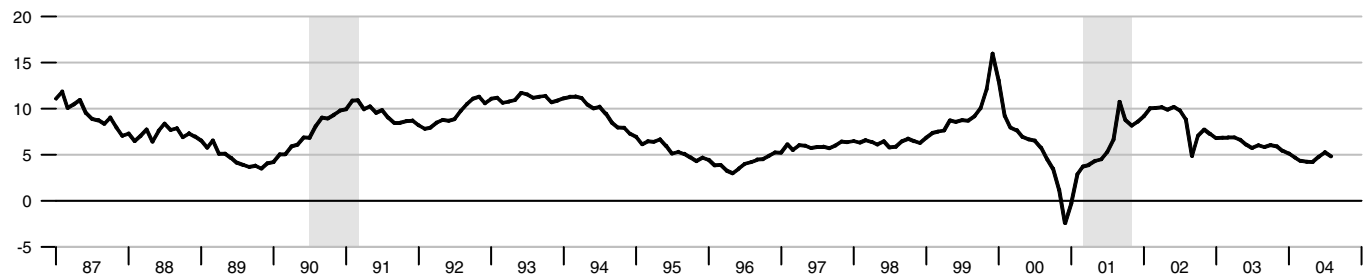
Monetary Services Index - M2

Percent change from year ago



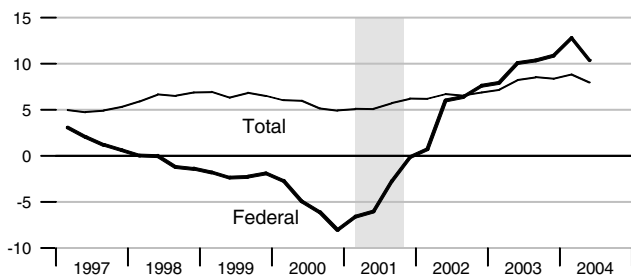
Adjusted Monetary Base

Percent change from year ago



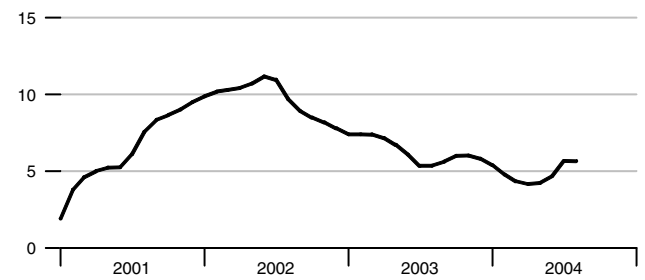
Domestic Nonfinancial Debt

Percent change from year ago



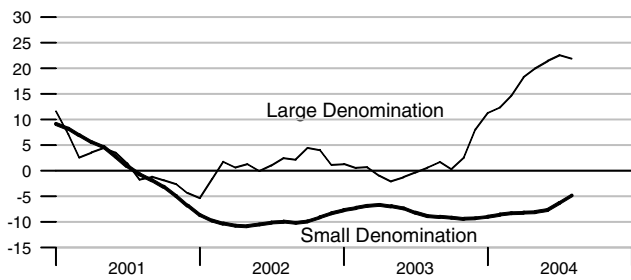
Currency Held by the Nonbank Public

Percent change from year ago



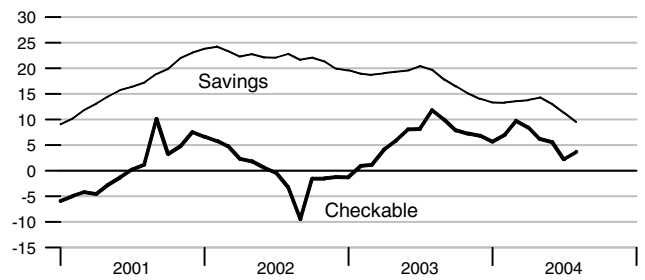
Time Deposits

Percent change from year ago



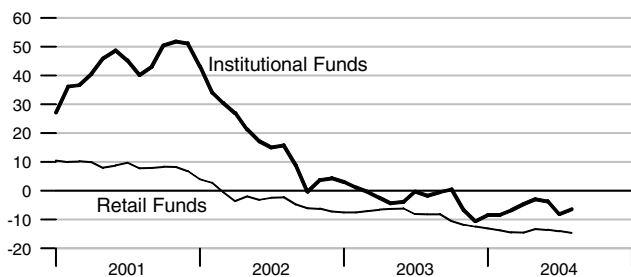
Checkable and Savings Deposits

Percent change from year ago



Money Market Mutual Fund Shares

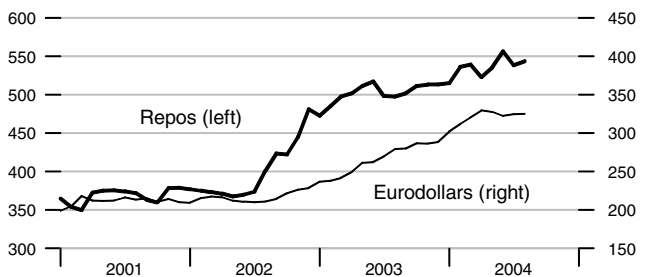
Percent change from year ago



Repurchase Agreements and Eurodollars

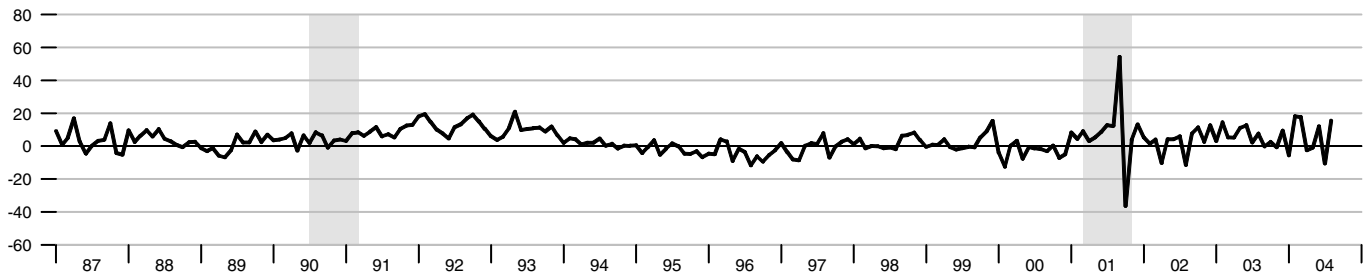
Billions of dollars

Billions of dollars



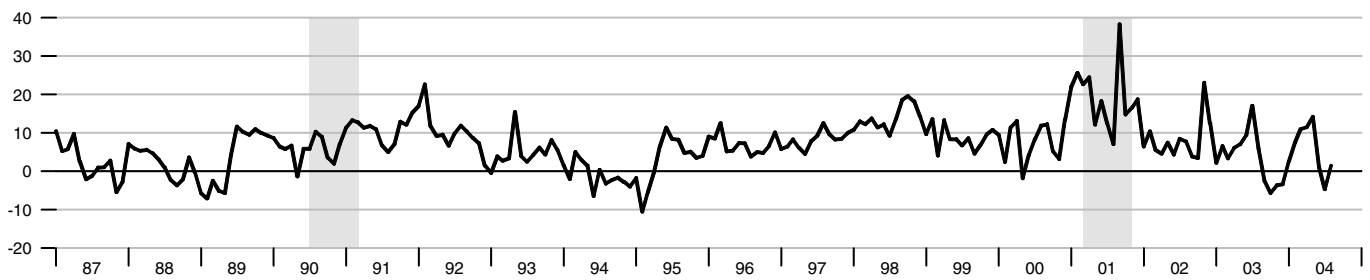
M1

Percent change at an annual rate



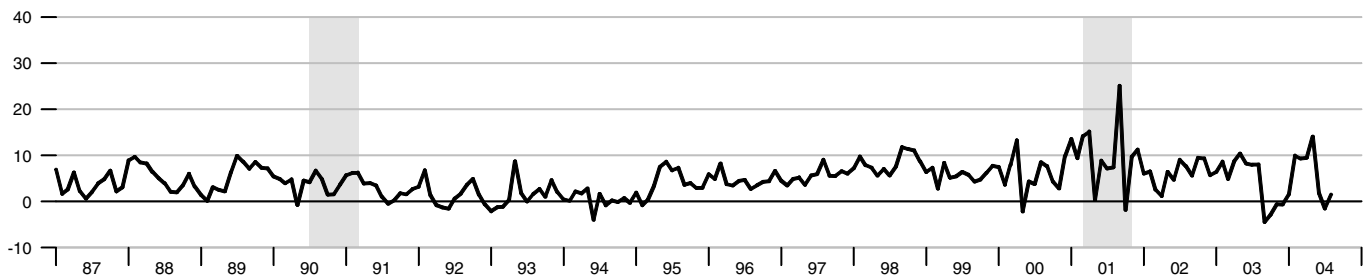
M2M

Percent change at an annual rate



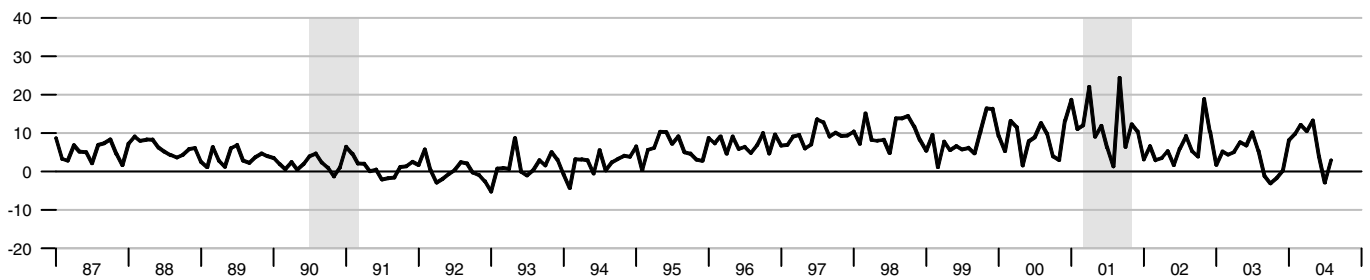
M2

Percent change at an annual rate



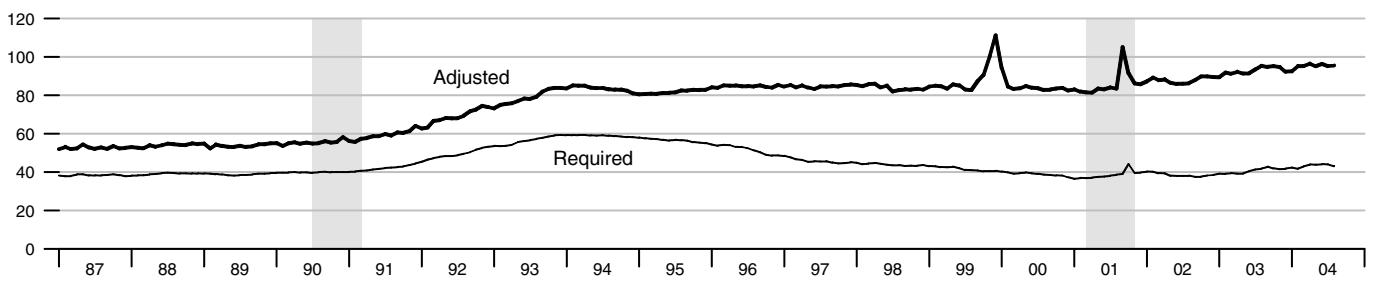
M3

Percent change at an annual rate



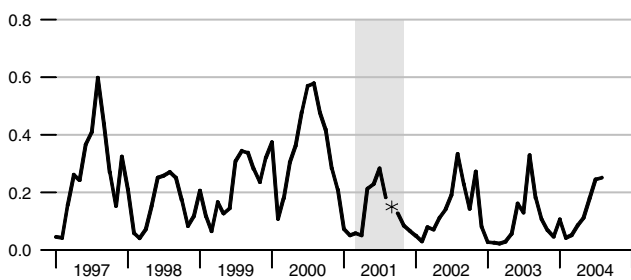
Adjusted and Required Reserves

Billions of dollars



Total Borrowings, nsa

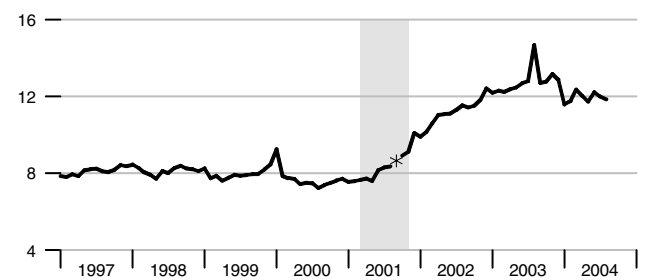
Billions of dollars



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

Excess Reserves plus RCB Contracts

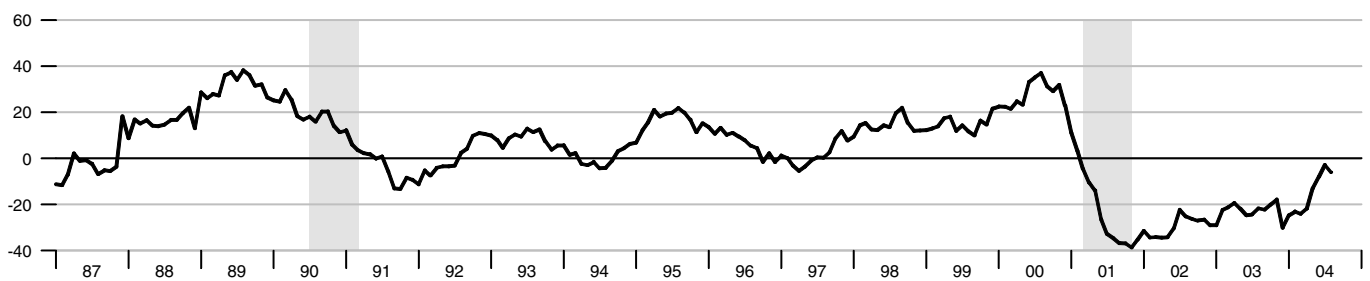
Billions of dollars



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

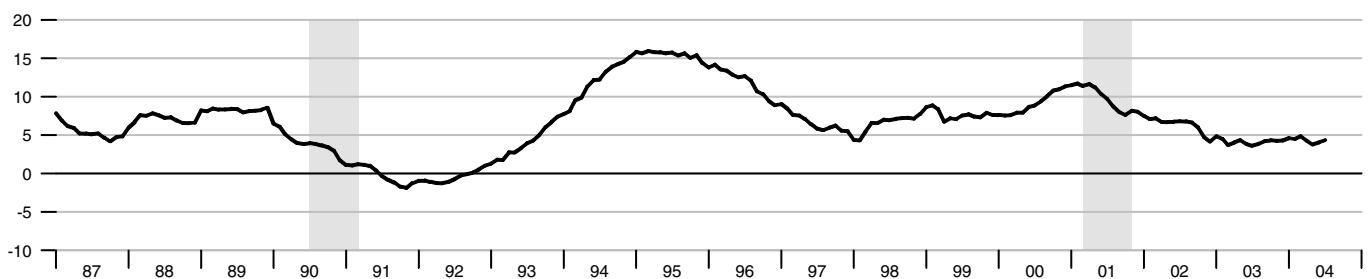
Nonfinancial Commercial Paper

Percent change from year ago

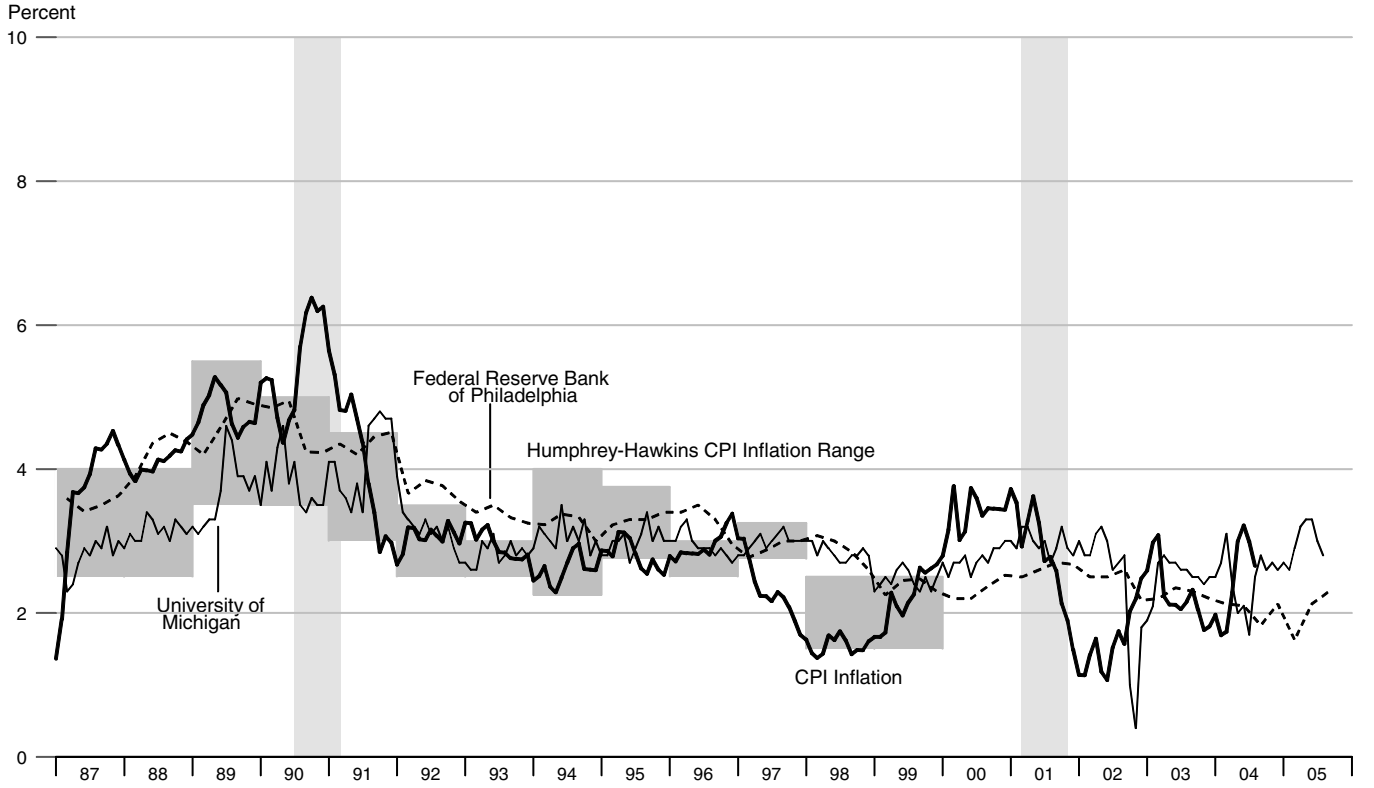


Consumer Credit

Percent change from year ago

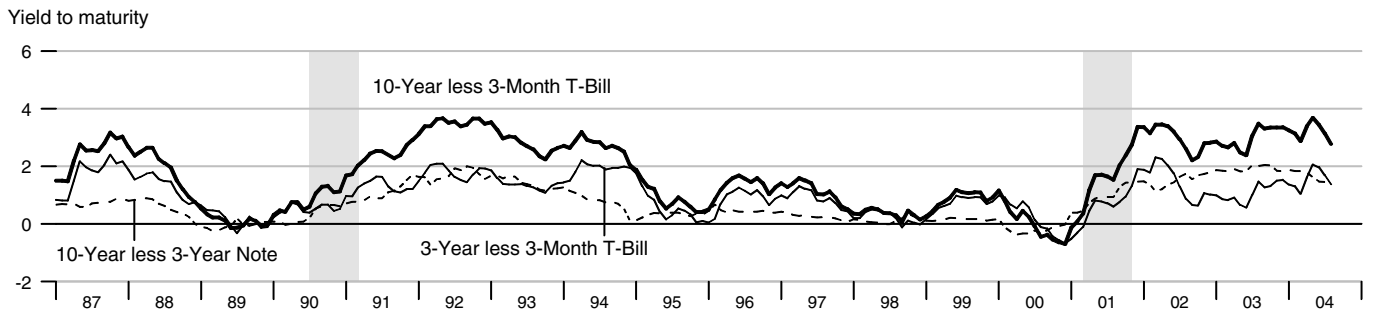


Inflation and Inflation Expectations

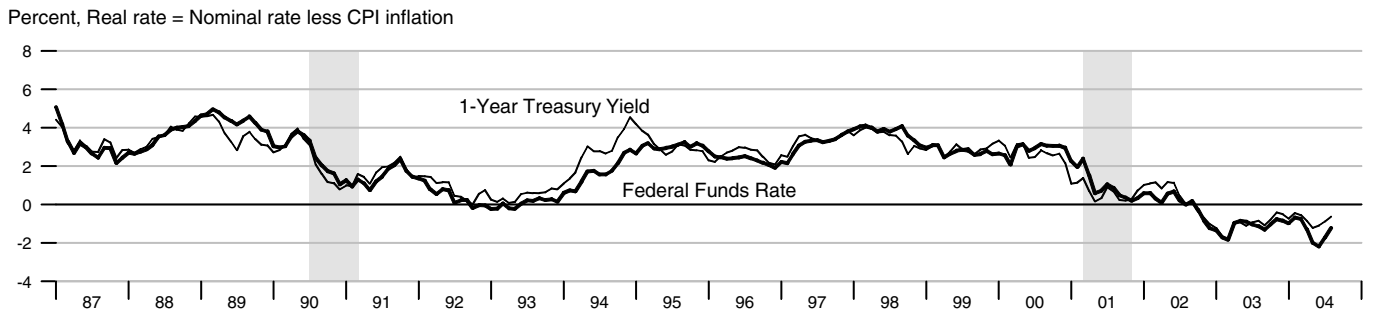


The shaded region shows the Humphrey-Hawkins CPI inflation range. Beginning in January 2000, the Humphrey-Hawkins inflation range was reported using the PCE price index and therefore is not shown on this graph. See notes on page 19.

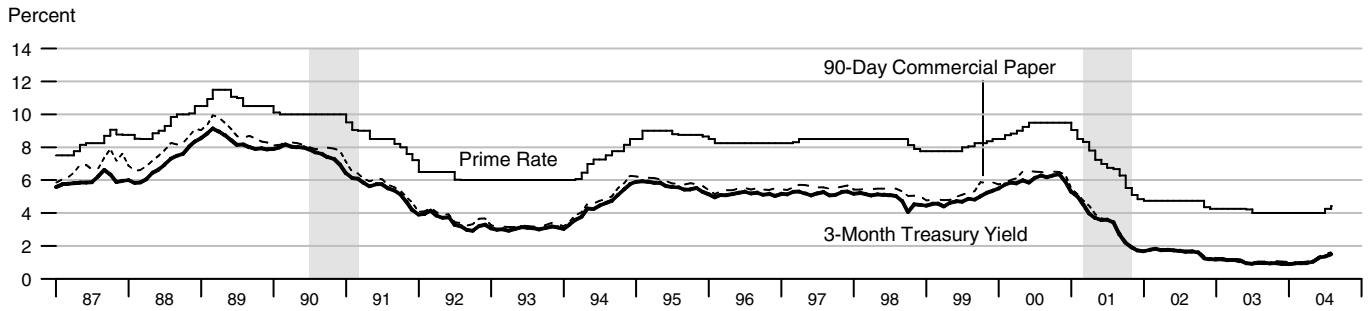
Treasury Security Yield Spreads



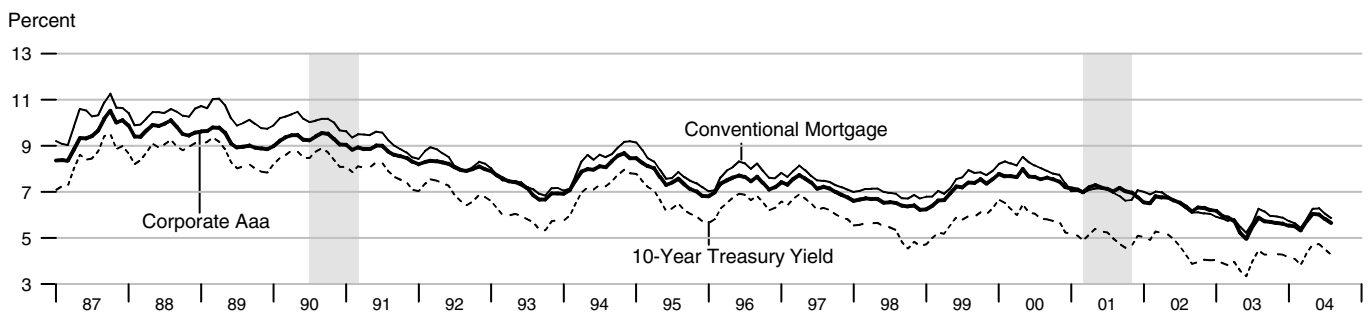
Real Interest Rates



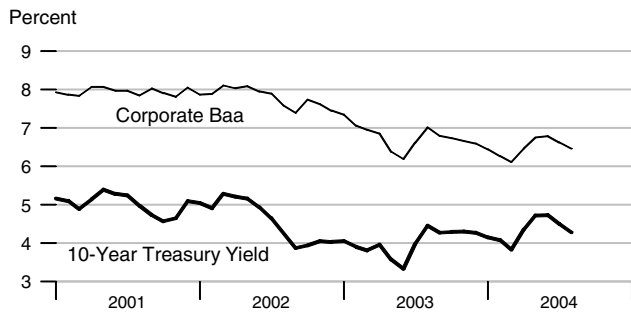
Short-Term Interest Rates



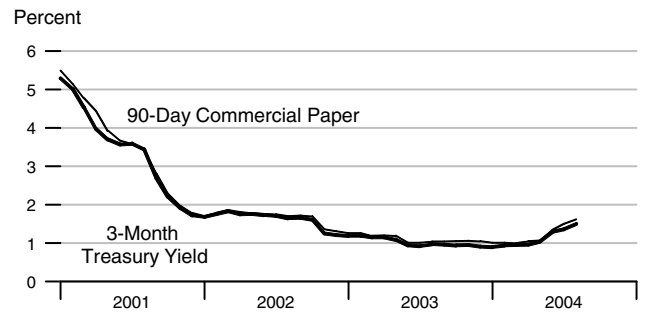
Long-Term Interest Rates



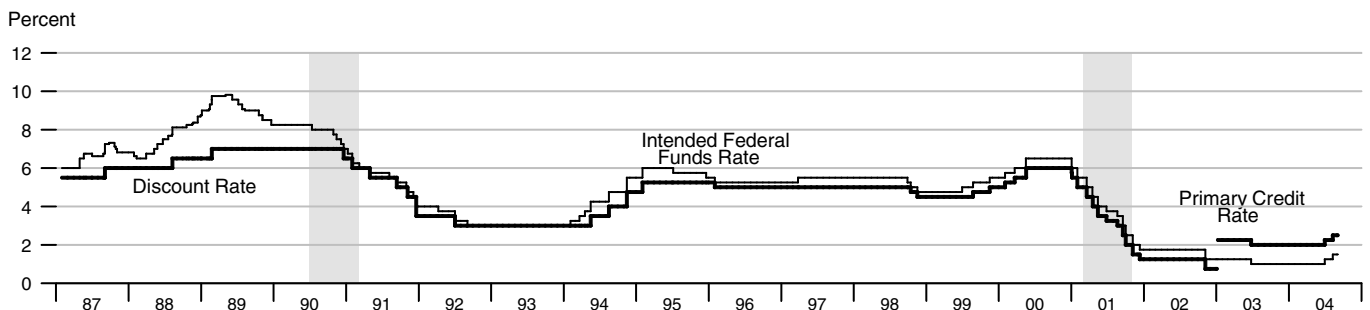
Long-Term Interest Rates



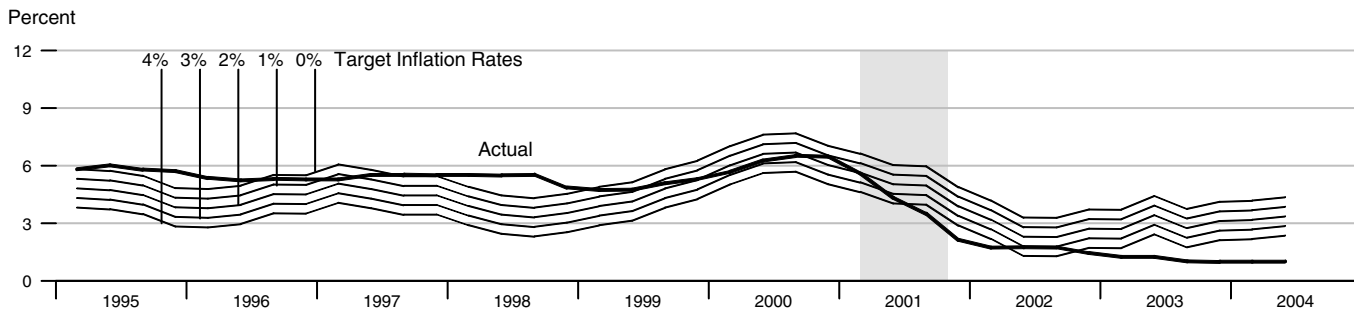
Short-Term Interest Rates



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



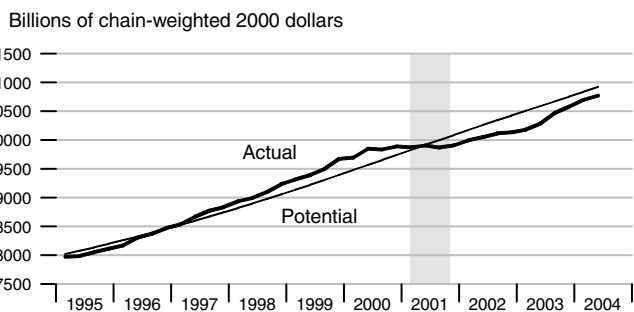
Federal Funds Rate and Inflation Targets



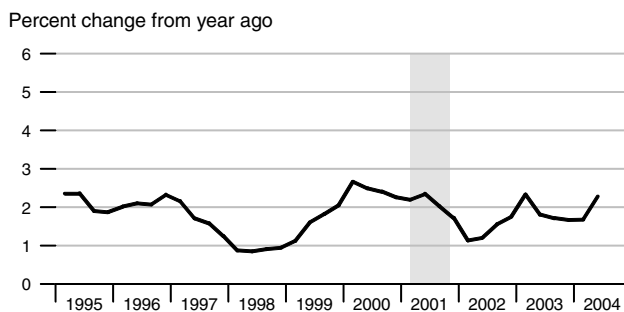
Calculated federal funds rate is based on Taylor's rule. See notes on page 19.

Components of Taylor's Rule

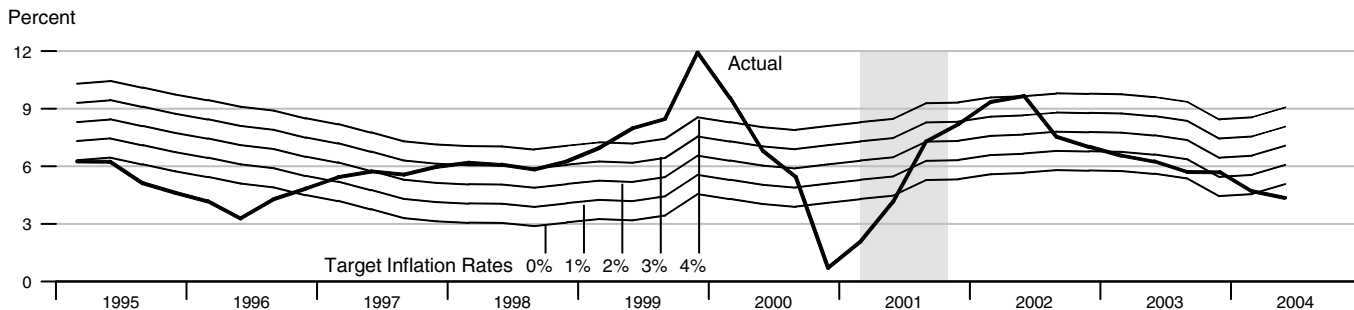
Actual and Potential Real GDP



PCE Inflation



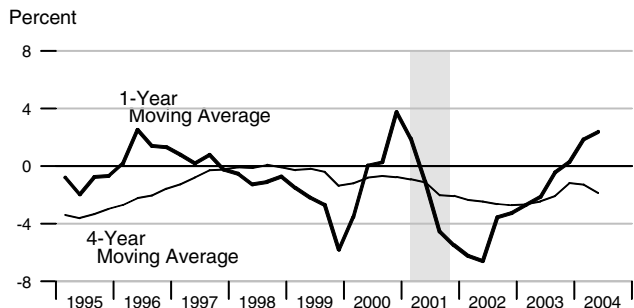
Monetary Base Growth* and Inflation Targets



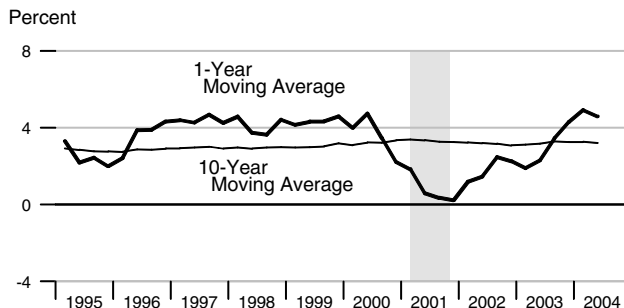
*Modified for the effects of sweeps programs on reserve demand. Calculated base growth is based on McCallum's rule. Actual base growth is percent change from year ago. See notes on page 19.

Components of McCallum's Rule

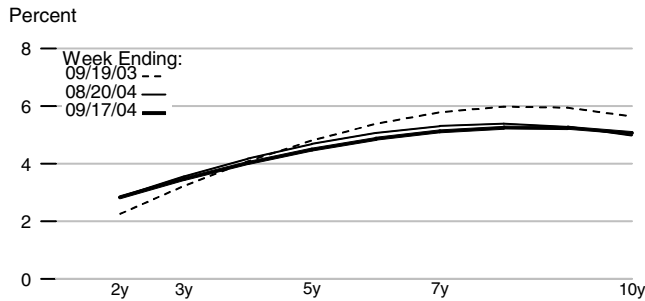
Monetary Base Velocity Growth



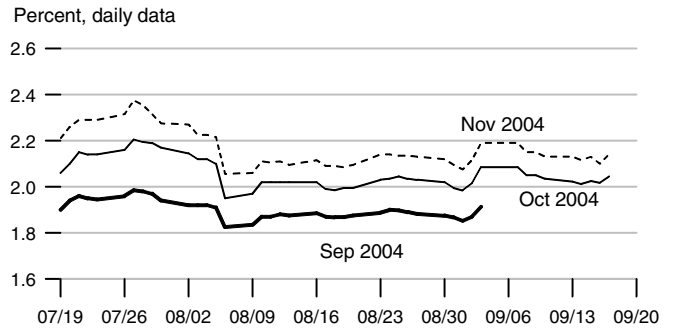
Real Output Growth



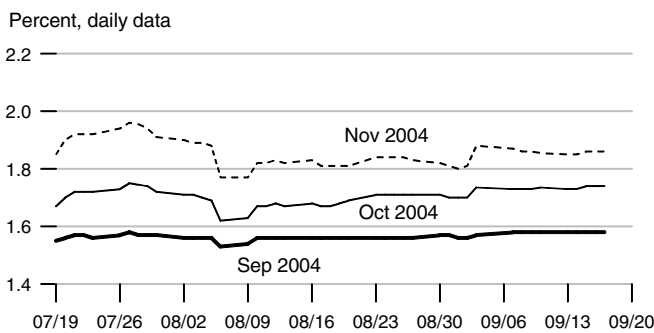
Implied One-Year Forward Rates



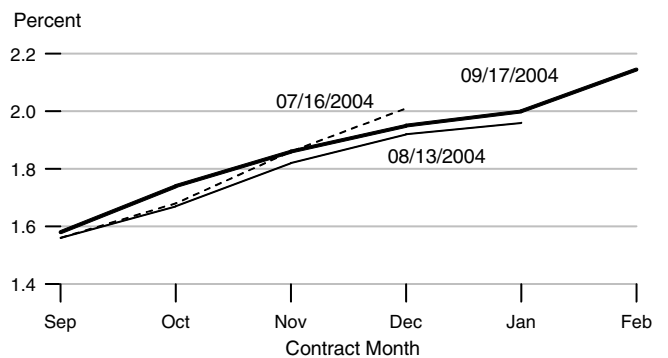
Rates on 3-Month Eurodollar Futures



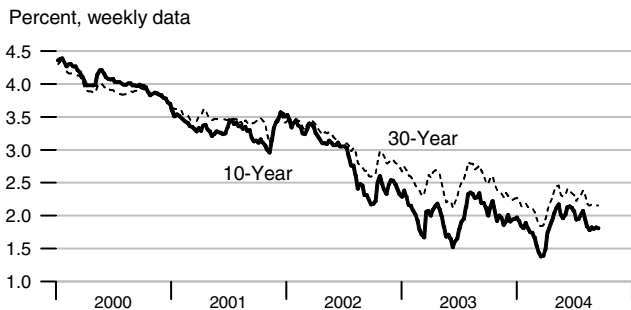
Rates on Selected Federal Funds Futures Contracts



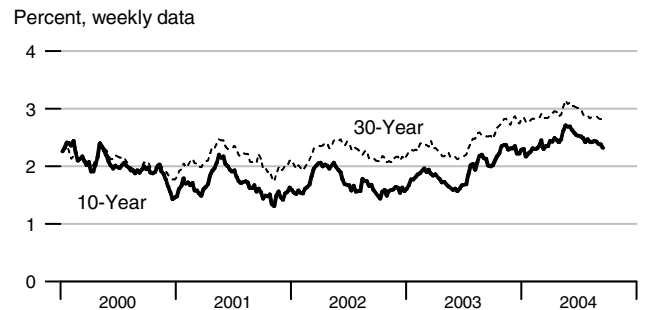
Rates on Federal Funds Futures on Selected Dates



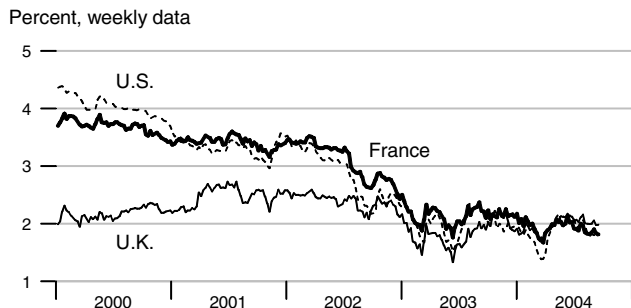
Inflation-Indexed Treasury Securities



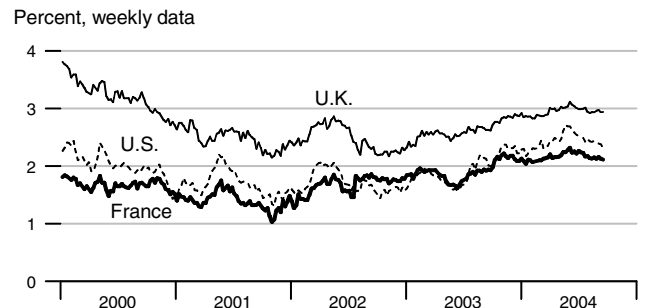
Inflation-Indexed Treasury Yield Spreads



Inflation-Indexed 10-Year Government Notes

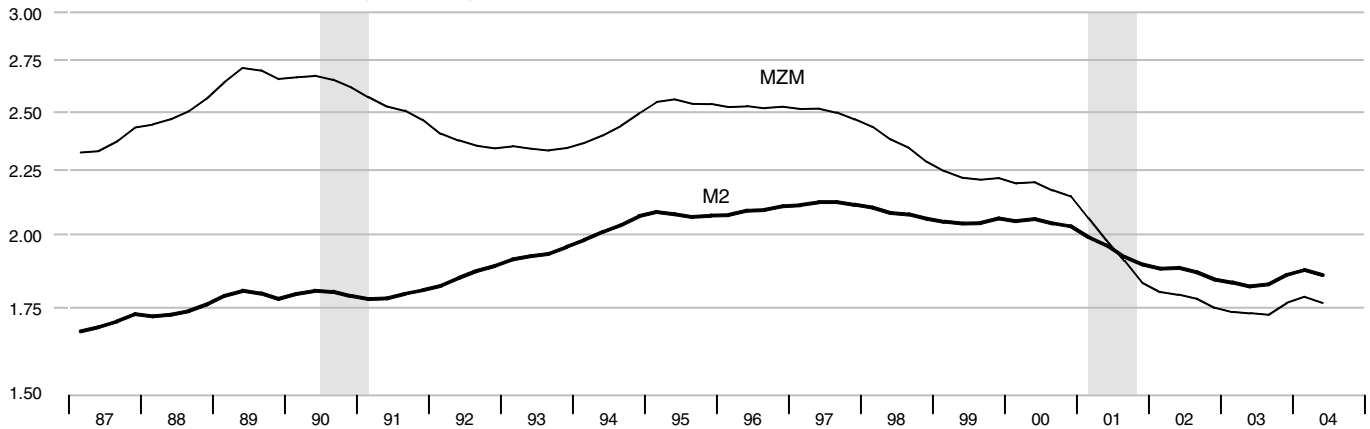


Inflation-Indexed 10-Year Government Yield Spreads



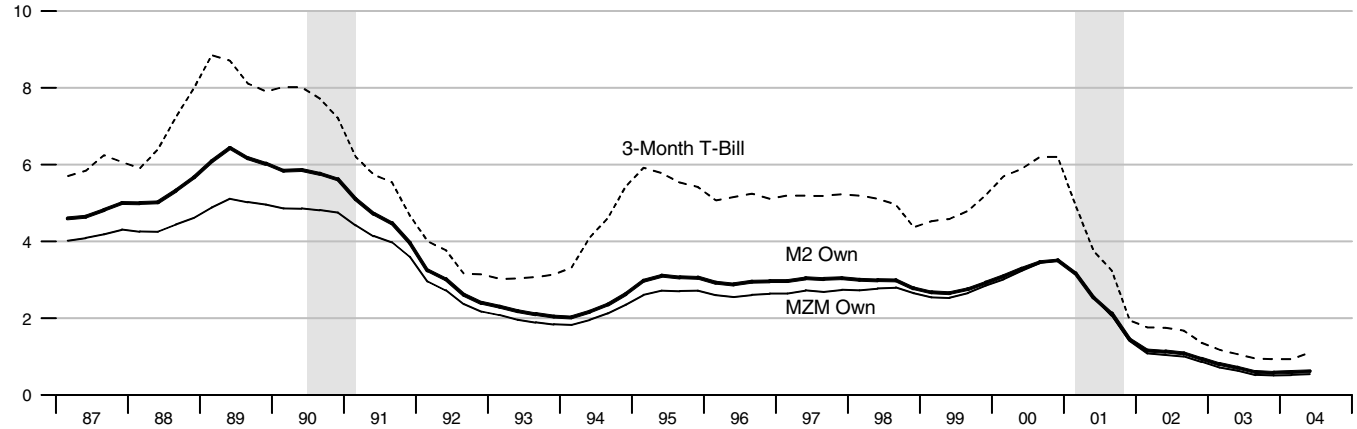
Velocity

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



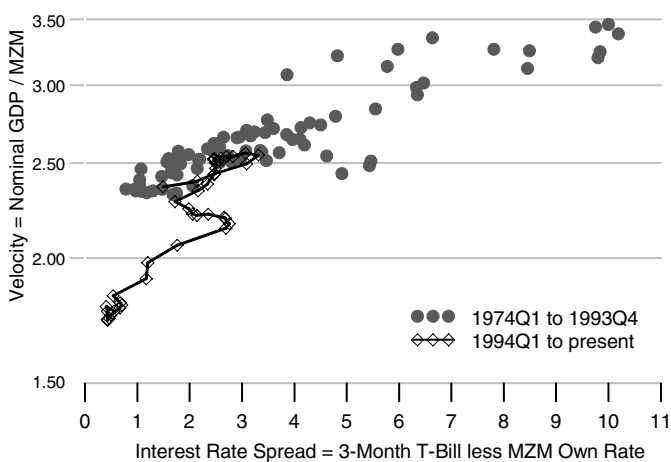
Interest Rates

Percent



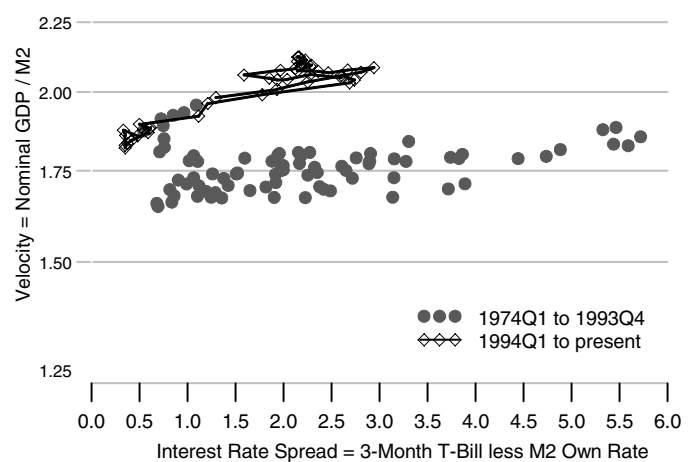
MZM Velocity and Interest Rate Spread

Ratio Scale



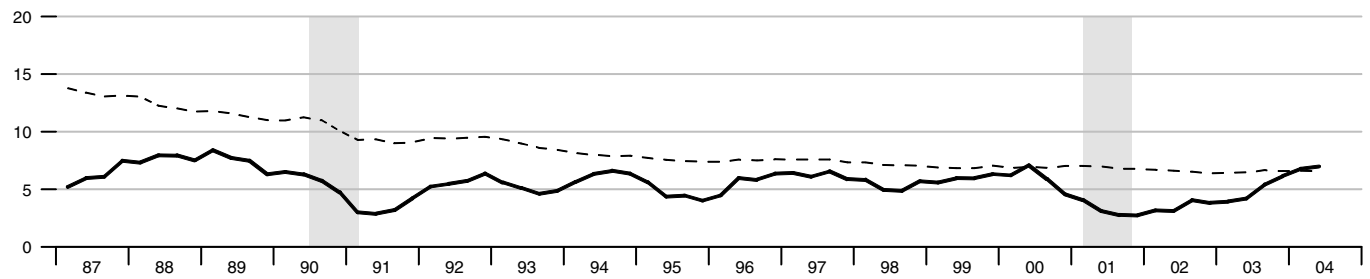
M2 Velocity and Interest Rate Spread

Ratio Scale



Gross Domestic Product

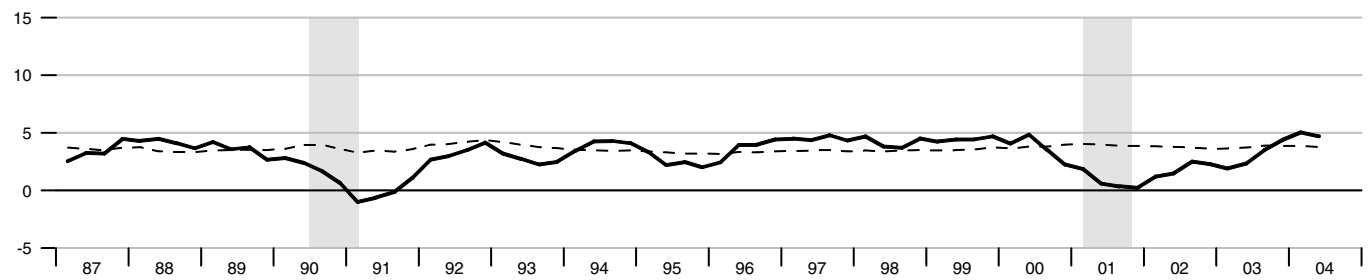
Percent change from year ago



Dashed lines indicate 10-year moving averages.

Real Gross Domestic Product

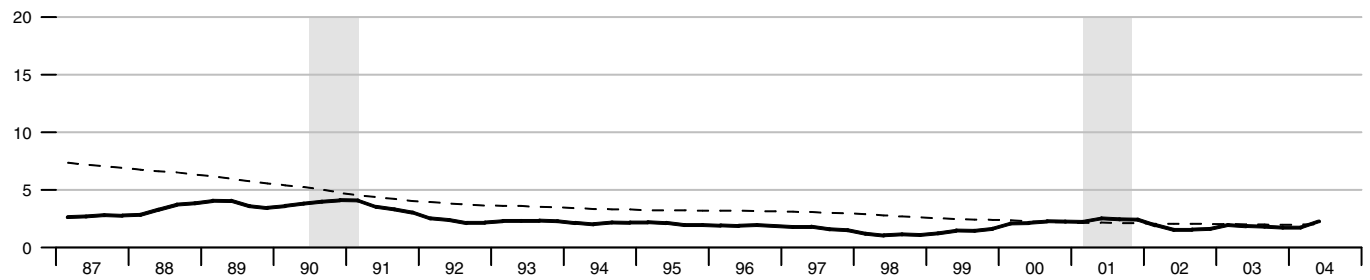
Percent change from year ago



Dashed lines indicate 10-year moving averages.

Gross Domestic Product Price Index

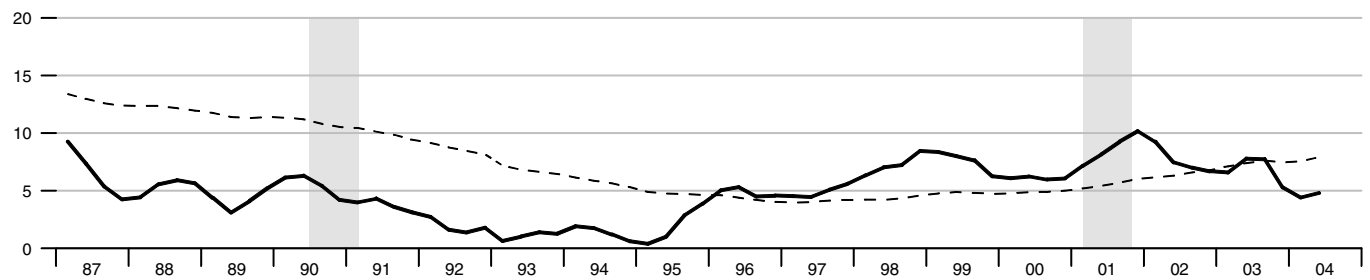
Percent change from year ago



Dashed lines indicate 10-year moving averages.

M2

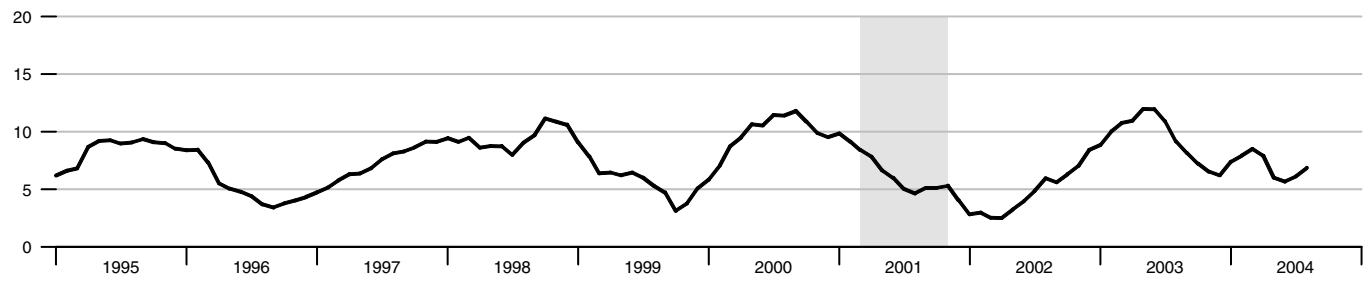
Percent change from year ago



Dashed lines indicate 10-year moving averages.

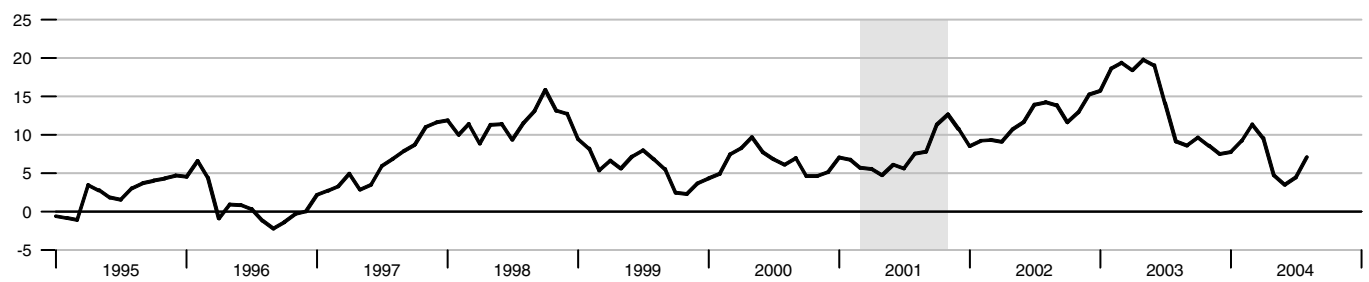
Bank Credit

Percent change from year ago



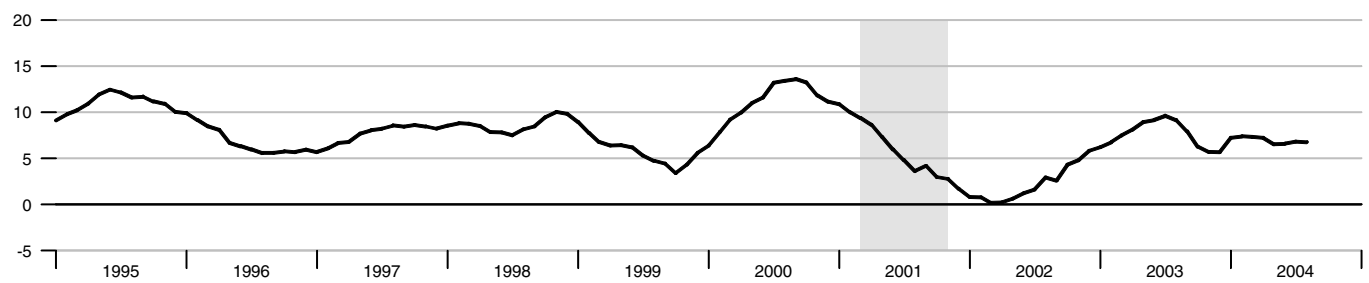
Investment Securities in Bank Credit at Commercial Banks

Percent change from year ago



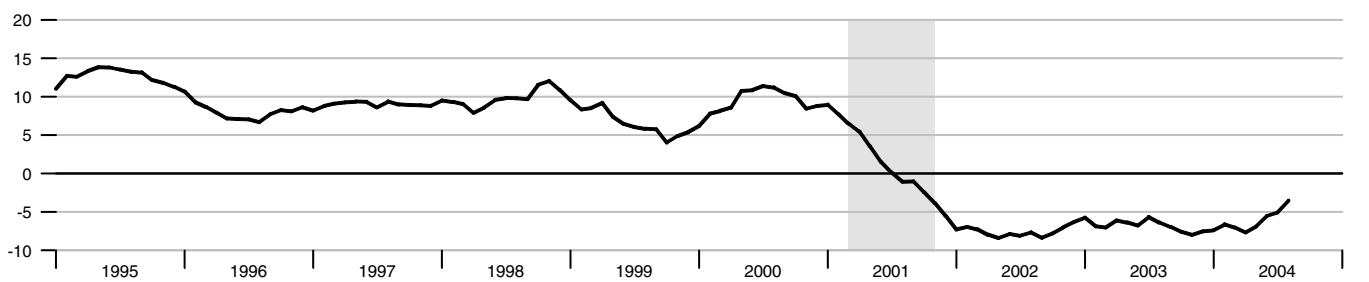
Total Loans and Leases in Bank Credit at Commercial Banks

Percent change from year ago

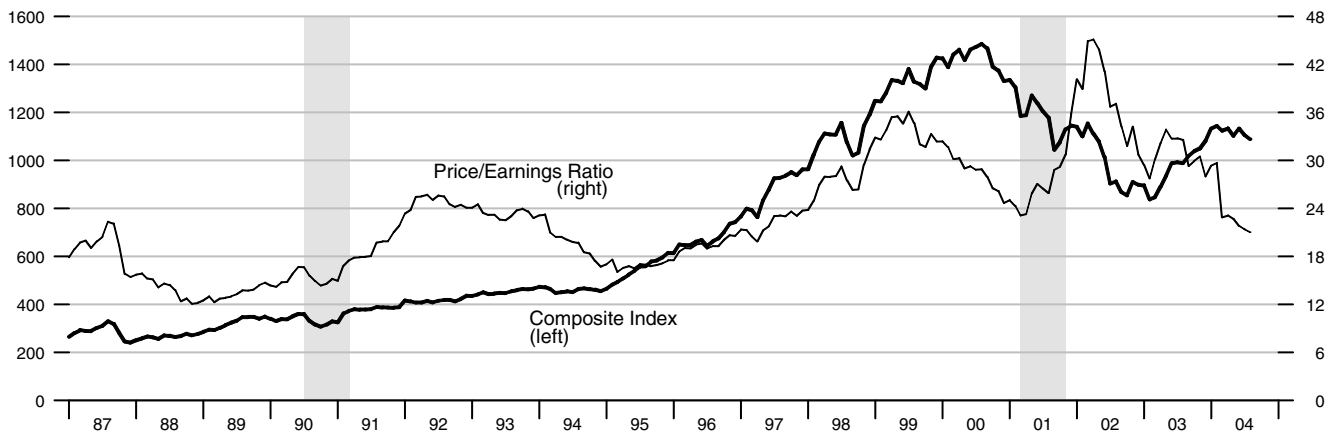


Commercial and Industrial Loans at Commercial Banks

Percent change from year ago



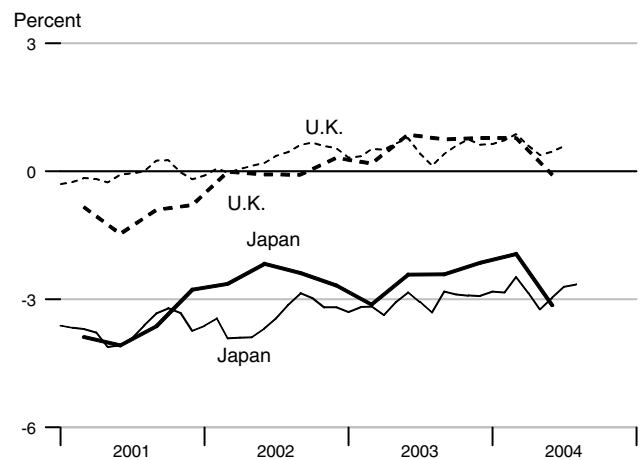
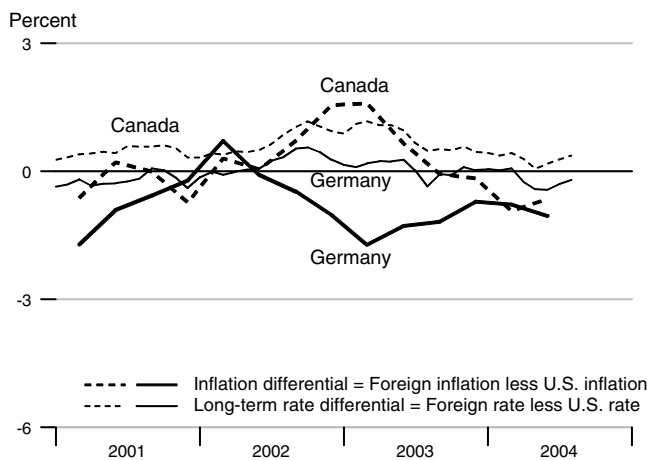
Standard & Poor's 500



Recent Inflation and Long-Term Interest Rates

	Consumer Price Inflation Rates				Long-Term Government Bond Rates			
	Percent change from year ago				Percent			
	2003Q3	2003Q4	2004Q1	2004Q2	May04	Jun04	Jul04	Aug04
United States	2.18	1.87	1.80	2.84	4.72	4.73	4.50	4.28
Canada	2.11	1.71	0.87	2.18	4.78	4.91	4.78	4.65
France	1.95	2.19	1.80	2.38	4.34	4.39	4.27	.
Germany	1.00	1.16	1.02	1.79	4.30	4.30	4.20	4.08
Italy	2.74	2.53	2.29	2.33	4.49	4.54	4.44	4.28
Japan	-0.24	-0.27	-0.14	-0.31	1.49	1.77	1.79	1.63
United Kingdom	2.93	2.65	2.58	2.75	5.10	5.19	5.09	.

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	4578.890	574.181	88.664	229.389
2000		1103.415	4508.945	4801.682	6852.007	5026.851	607.106	84.511	242.177
2001		1136.880	5221.045	5219.653	7632.944	5347.555	641.167	85.923	263.729
2002		1191.998	5891.326	5614.803	8244.826	5599.022	697.072	87.914	285.723
2003		1263.997	6322.064	5998.586	8761.178	6122.207	740.674	92.828	305.770
2002	1	1186.889	5741.673	5499.716	8082.087	5421.939	680.264	88.149	279.213
	2	1184.073	5828.690	5549.617	8161.282	5498.309	692.937	86.970	282.329
	3	1189.213	5927.543	5648.402	8275.904	5657.550	702.753	86.805	287.729
	4	1207.817	6067.399	5761.477	8460.032	5818.289	712.332	89.733	293.619
2003	1	1232.004	6187.293	5861.339	8599.997	5957.223	726.828	90.856	298.747
	2	1258.261	6282.236	5981.702	8723.389	6137.702	738.230	91.757	304.838
	3	1278.765	6433.579	6085.531	8872.374	6188.379	743.993	94.581	310.160
	4	1286.957	6385.149	6065.772	8848.954	6205.524	753.644	94.119	309.336
2004	1	1306.890	6425.981	6119.417	8983.912	6430.599	761.085	94.363	312.256
	2	1327.310	6593.977	6268.494	9225.354	6537.625	770.822	96.014	319.997
2002	Aug	1182.885	5933.903	5651.538	8284.826	5663.517	702.878	86.366	287.926
	Sep	1190.531	5952.815	5677.890	8321.286	5721.978	704.350	87.962	289.330
	Oct	1201.818	5969.836	5722.696	8348.287	5748.126	710.666	89.805	291.621
	Nov	1204.472	6084.499	5767.200	8479.398	5819.943	712.475	89.818	293.937
	Dec	1217.161	6147.863	5794.536	8552.410	5886.797	713.854	89.575	295.299
2003	Jan	1220.382	6159.131	5825.525	8564.760	5889.793	719.531	89.449	296.929
	Feb	1235.054	6192.703	5867.344	8601.856	5971.512	728.668	91.828	299.044
	Mar	1240.575	6210.044	5891.147	8633.374	6010.364	732.286	91.291	300.268
	Apr	1246.093	6241.488	5933.849	8670.375	6050.302	736.491	92.283	302.429
	May	1257.661	6277.882	5985.144	8725.214	6154.609	738.664	91.428	305.002
	Jun	1271.030	6327.337	6026.113	8774.577	6208.194	739.536	91.559	307.082
	Jul	1273.435	6417.229	6066.128	8848.971	6196.479	741.241	93.485	309.153
	Aug	1281.496	6448.836	6106.591	8888.596	6181.483	745.242	95.383	311.207
	Sep	1281.363	6434.671	6083.873	8879.555	6187.176	745.496	94.876	310.121
	Oct	1284.074	6404.316	6069.055	8856.833	6163.800	753.680	95.231	309.422
	Nov	1283.390	6384.628	6065.799	8844.422	6200.210	754.634	94.768	309.369
	Dec	1293.406	6366.504	6062.462	8845.607	6252.562	752.618	92.359	309.217
2004	Jan	1287.449	6379.956	6070.129	8905.332	6324.742	756.452	92.550	309.807
	Feb	1306.948	6419.683	6120.254	8977.850	6445.113	762.848	95.239	312.307
	Mar	1326.274	6478.305	6167.868	9068.553	6521.942	763.956	95.299	314.654
	Apr	1323.491	6540.609	6216.856	9148.118	6528.903	767.619	96.485	317.265
	May	1322.586	6617.700	6289.640	9249.040	6523.492	769.877	95.187	321.126
	Jun	1335.852	6623.622	6298.986	9278.904	6560.481	774.969	96.371	321.599
	Jul	1324.139	6597.708	6290.882	9256.632	6575.458	780.298	95.280	321.440
	Aug	1341.267	6605.401	6298.537	9278.851	6605.138	781.262	95.588	321.719

*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	5.61
	2	1.01		2.00	4.00	1.25	1.10	2.98	4.60	5.93	4.82	6.13
2002	Aug	1.74	1.25	4.75	1.73	1.65	2.52	4.26	6.37	4.78	6.29	
	Sep	1.75	1.25	4.75	1.76	1.66	2.32	3.87	6.15	4.58	6.09	
	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		2.25	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	5.74
	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	4.00	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	4.42	1.68	1.50	2.88	4.28	5.65	4.52	5.87

*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	6.25	10.46	9.74	10.75
<hr/>					
2002	Aug	-11.39	7.73	7.64	9.23
	Sep	7.76	3.82	5.60	5.28
	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
<hr/>					
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
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2004	Jan	-5.53	2.54	1.52	8.10
	Feb	18.17	7.47	9.91	9.77
	Mar	17.74	10.96	9.34	12.12
	Apr	-2.52	11.54	9.53	10.53
	May	-0.82	14.14	14.05	13.24
	Jun	12.04	1.07	1.78	3.87
	Jul	-10.52	-4.69	-1.54	-2.88
	Aug	15.52	1.40	1.46	2.88

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