

Monetary Trends



The Preemptive Fed

In February 2000, the Federal Open Market Committee (FOMC) began releasing an assessment of the risks of either “heightened inflation pressures” or “economic weakness.” This forward-looking assessment suggests that the FOMC is prepared to take preemptive policy actions when warranted. At the first seven of its eight meetings in 2000, the FOMC concluded that the risk of heightened inflation pressures predominated, and tightened policy at the first three of those meetings. By the December 2000 meeting, however, the FOMC judged that economic growth may be slowing to an extent that the “risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.” How did financial markets respond to the policy easing—a 50 basis point decrease in the federal funds target rate—on January 3, 2001, in light of the risk assessment issued at the FOMC meeting on December 19, 2000?

To put the reaction of financial markets in context, note that the FOMC’s press releases on December 19, 2000, and January 3, 2001, described current inflation pressures as “diminished” and “contained.” In contrast, in the spring of 1990, as the economy was about to dip into recession, the inflation rate was “uncomfortable and unacceptable,” as described by one FOMC member. Thus, unlike 1990, the FOMC in early 2001 is not faced simultaneously with a possibly weakening economy and uncomfortably high inflation.

The accompanying chart shows the responses of the Treasury yield curve and the forward exchange rate premium (between the dollar and the euro) to the recent policy announcements and easing. The slope of the yield curve is measured as the difference in yields between the 10-year Treasury bond and the three-month Treasury bill. A strongly inverted (negatively sloped) yield curve is often considered a sign of a possible impending recession. Following the recent policy easing, the slope of the yield curve increased. (A

short-lived increase in slope followed the December 19 risk assessment, but it was due to strong year-end demand for Treasury bills unrelated to monetary policy.)

The forward exchange rate premium is expressed as the percentage difference between the one-year forward rate (in dollars per euro) and the spot rate. Because real interest rates are procyclical, recession fears would lead to expectations of reductions in real interest rates in the United States—which generally are thought to have a negative impact on the future value of the dollar. If monetary policy steps are believed to reduce the risk of recession, then the forward premium (in dollars per euro) would be expected to decrease—precisely what happened following the January 3 policy easing.

In addition, stock markets responded strongly on January 3 to the FOMC policy easing, with the NASDAQ posting its largest one-day gain ever. Hence, a broad spectrum of financial markets—bond, equity and foreign exchange—reacted to the FOMC’s action on January 3 in a way consistent with the view that the policy easing was a preemptive move to lessen the likelihood of a recession.

—Michael Dueker

