

A beginner's mistake that all too often is made by more experienced analysts is to assess monetary policy by the direction and size of recent movements in short-term interest rates. What matters instead is where the Fed has been pegging short-term rates relative to where they would have been in the absence of Fed intervention.

At any moment, the stance of monetary policy is the difference between the level at which short rates are being pegged and the rate at which money markets would otherwise clear. But this is just the instantaneous impact of monetary policy. What matters for the price level is the cumulative effect of all past stances, or the thrust of monetary policy.

The catch, of course, is that the equilibrium level of rates in the absence of Fed intervention is unobservable. It exists, but cannot be observed. It can be estimated, however, based on trends in economic growth, inflation expectations and uncertainty regarding future inflation.

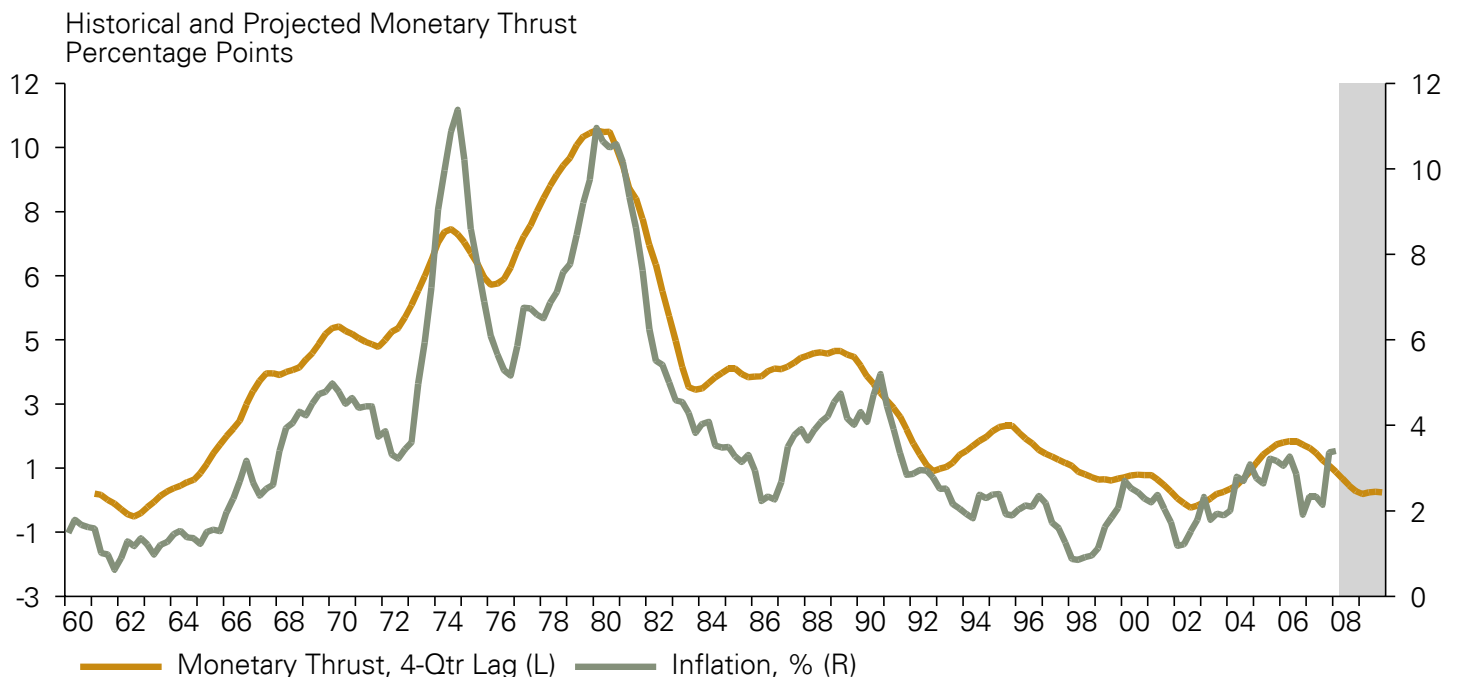
The graph below shows the rate of inflation measured as the 4-quarter percent change in the personal consumption

Far from being inflationary, monetary policy is neutral or even modestly disinflationary. The elevated rate of inflation is the temporary result of high energy prices, and will give way to lower inflation over the next two years.

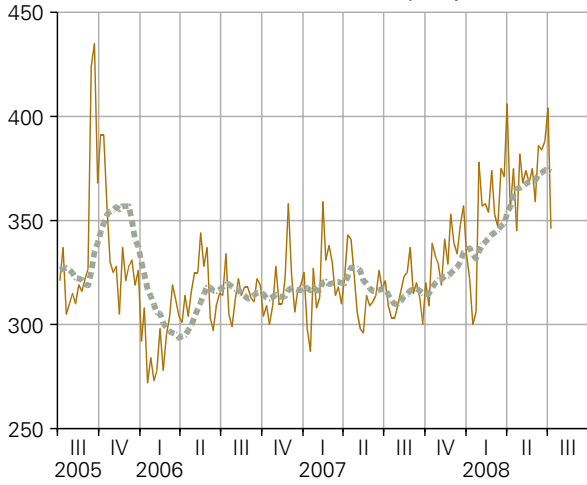
deflator (gray line) and our calculation of monetary thrust (copper line) since 1960. Very importantly, monetary thrust is lagged by 4 quarters, because changes in the stance of policy take time to affect the price level.

The message is that monetary policy is not inflationary. To the contrary, the thrust of monetary policy is neutral or even modestly disinflationary. The elevated rate of some inflation measures today is the temporary result of high energy prices, and will give way to lower inflation over the next two years.

Jim Coons



Initial Claims for Unemployment Insurance
Thousands Per Week, Seasonally Adjusted



U. S. Dollar Exchange Rate
FRB Major Currency Index, 1973 = 100



Price of Oil
West Texas Int, \$/bbl



Price of Gold
London PM Fixing, \$/oz



S&P 500 Stock Prices
Daily Close, Index 1941-43 = 10



Mortgage Loan Originations
MBA Purchase Index 3/16/90=100 SA

