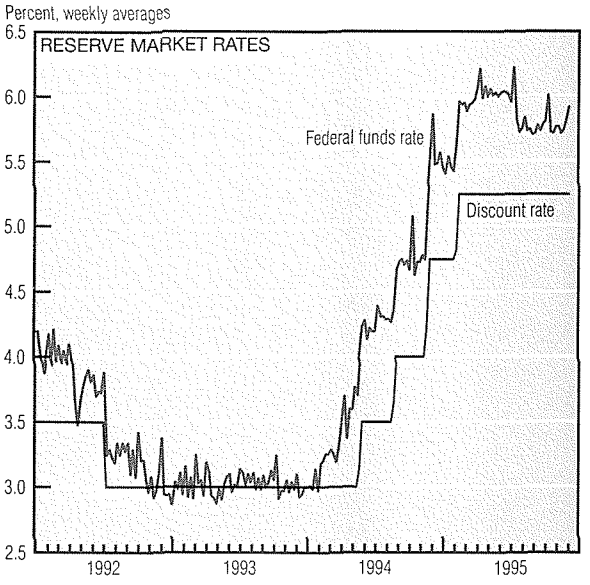
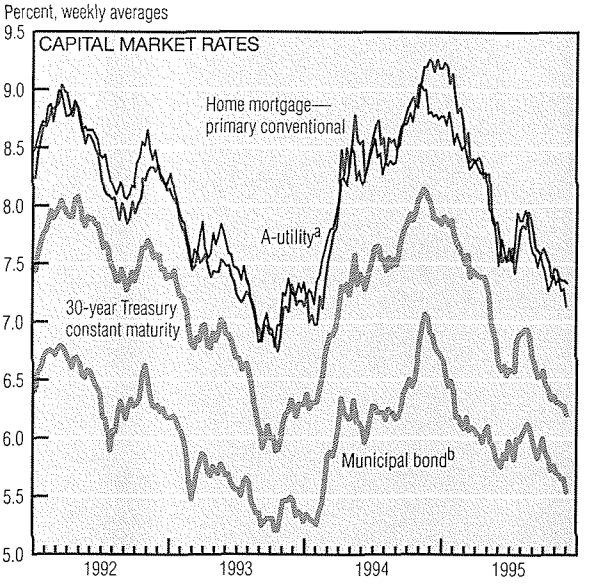
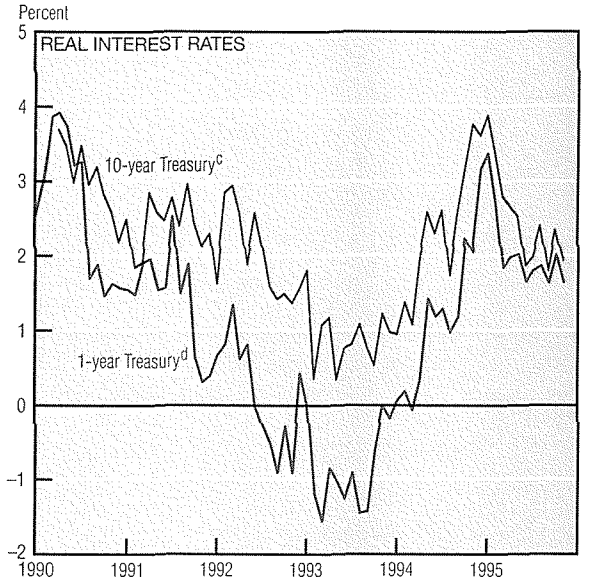
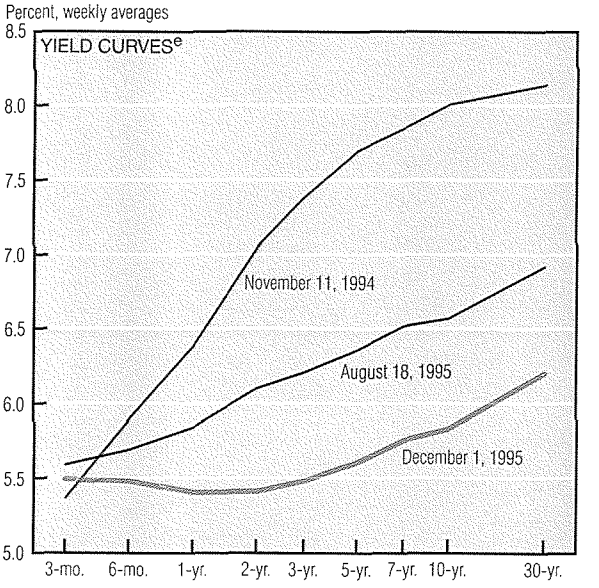
Monetary Policy









a. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.
b. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
c. 10-year Treasury yield minus five- to 10-year mean inflation expectations as measured by the University of Michigan's Survey of Consumers.
d. One-year Treasury yield minus one-year mean inflation expectations as measured by the University of Michigan's Survey of Consumers.
e. Three-month, six-month, and one-year instruments are quoted from the secondary market on a yield basis; all other instruments are constant-maturity series.
SOURCES: Board of Governors of the Federal Reserve System; and the University of Michigan.

Despite the absence of any explicit policy action by the Federal Open Market Committee (FOMC), interest rates have fallen across the spectrum of maturities since mid-August. Thirty-year Treasury bond rates have dropped more than 60 basis points, while three-month T-bill rates are down about 10 basis points. Thus, the yield curve has flattened significantly, but it still slopes upward.

Since the cyclical peak in long-term rates in November 1994, long-term bond yields have fallen 2 percentage points, while short-term rates remain slightly above their levels at that time. The downward swing in the yield curve over this period has been rather dramatic, as has the rise in the stock market. The sag in the yield curve around the one- to two-year maturities suggests that market participants expect further cuts in the federal funds rate over the next year.

Real interest rates are also down substantially from their January 1995 peaks. The short-term real interest rate—as measured by the one-year Treasury rate less expected inflation—stands just above 1½%, near levels registered in June and September of this year. The real long-term rate— as measured by the 10-year Treasury rate less expected inflation—is just under 2%.

Many analysts have attributed part of the downward trend in capital market rates to the public's increasing conviction that Congress and the

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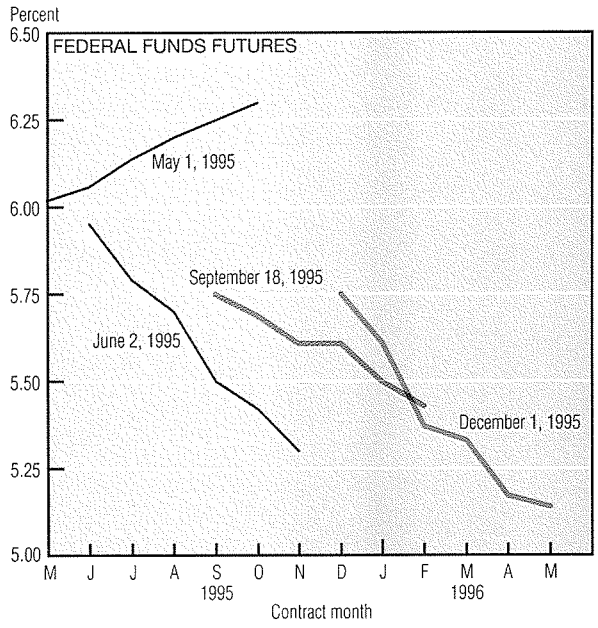
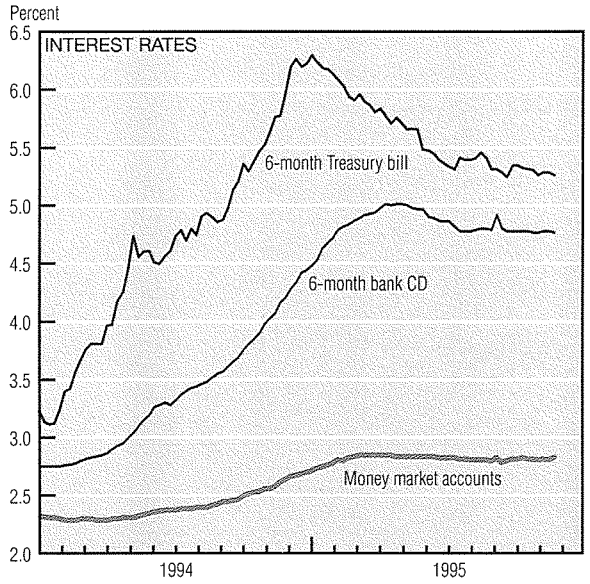
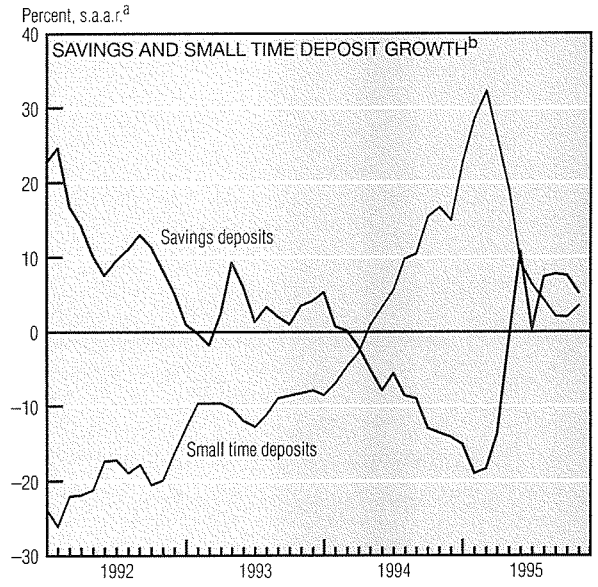
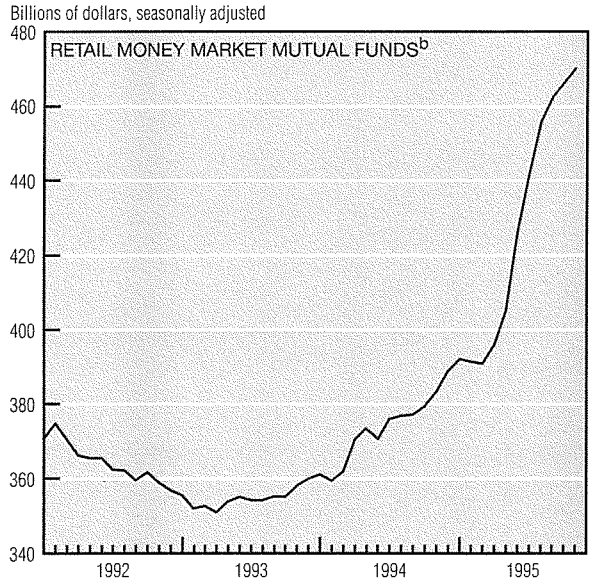
Monetary Policy (cont.)









a. Seasonally adjusted annual rate.
b. Last plot is estimated for November 1995.
SOURCES: Chicago Board of Trade; Board of Governors of the Federal Reserve System; and *Bank Rate Monitor,* various issues.

administration will produce a credible deficit-reduction package. Nevertheless, it is difficult to identify the fundamentals behind changing interest rates, since other factors may be involved. For example, the demand for bank loans, which was strong over most of the past year, has tapered off in recent months. On the other hand, business investment remains robust, suggesting that the real rate of return on new plant and equipment is still relatively high.

Fed funds futures markets reveal that the FOMC is again expected to lower its funds-rate objective sometime over the next few months. Such a move was projected to occur earlier this year, but the policy change failed to materialize. More recently, the projected funds-rate decline has been accompanied by evidence that inflation is somewhat lower than expected in the second half of 1995.

Yields on some bank deposits fell early this year, but have remained relatively steady since then. As a consequence, the opportunity cost of M2—largely the difference between market rates on tradable short-term securities and rates paid on bank deposits—has stabilized. The effect of this stability is most evident in the recent growth rates of small time and savings deposits, which have fluctuated much less.

During 1995, growth in retail money market mutual funds exploded despite declining yields. Some analysts have attributed this to

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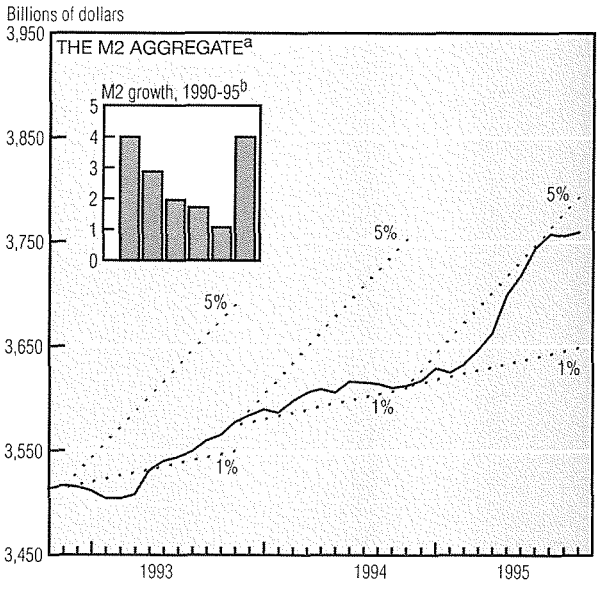
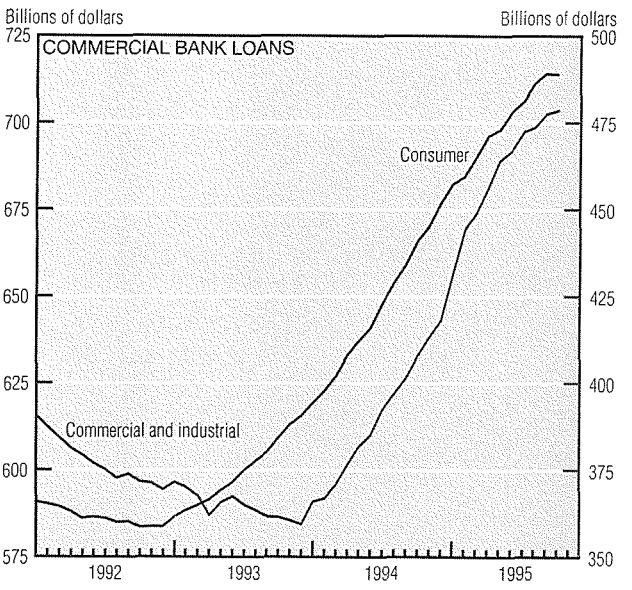
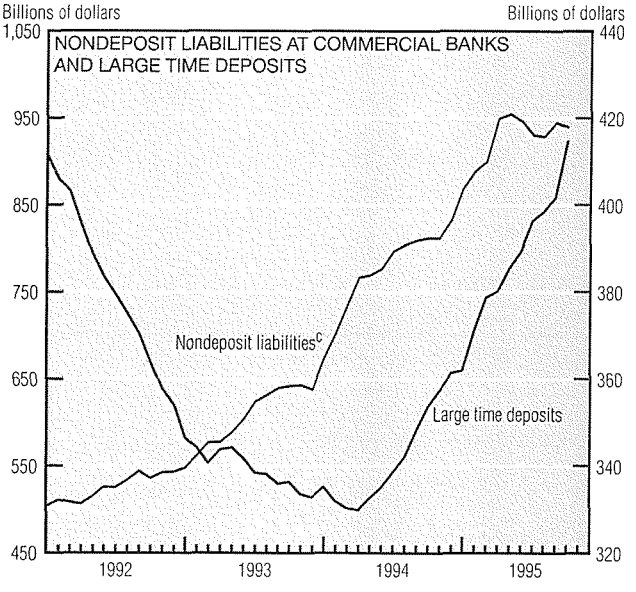
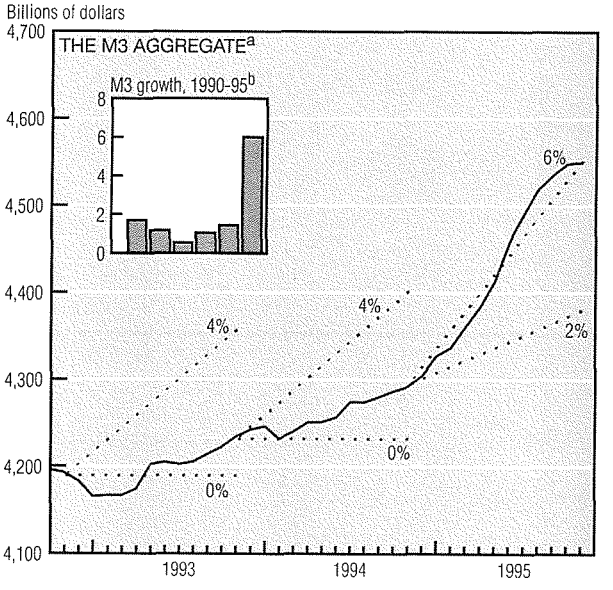
Monetary Policy (cont.)









a. Last plot is estimated for November 1995.
b. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1995 is calculated on an estimated November over 1994:IVQ basis.
c. Nondeposit liabilities are total liabilities minus deposits and borrowings from banks in the U.S.
NOTE: All data are seasonally adjusted. Dotted lines are target ranges.
SOURCE: Board of Governors of the Federal Reserve System.

the flattening of the yield curve, which has induced security holders to shorten the maturity of their portfolios. In recent months, however, growth in money funds has slowed somewhat.

With M2 opportunity cost holding steady, M2 growth has climbed to near 4% this year. This pace is more commensurate with historical experience and suggests that special factors damping the aggregate's growth in recent years may have lessened.

Market analysts believe that M2's unusual behavior was a consequence of fundamental changes in the way households managed their portfolios. These changes were largely induced by an environment in which banks had limited opportunities for making good loans. Absent such opportunities, banks could not aggressively compete for funds by offering attractive yields on deposits. Higher-yielding bond mutual funds attracted the attention of deposit holders, who for the first time added bond funds to their portfolios. These conditions led to a massive substitution of bank deposits for bond funds, which are not included in M2. The recent cessation of net inflows into bond funds suggests that M2 may resume more normal growth.

The engine of deposit growth in the recent past has been strong loan demand from both consumers and businesses. In 1995, banks increasingly turned to large time deposits to fund new loans. As a consequence, M3, which includes large time deposits, has expanded a healthy 6% this year.

Recently, some unusual factors

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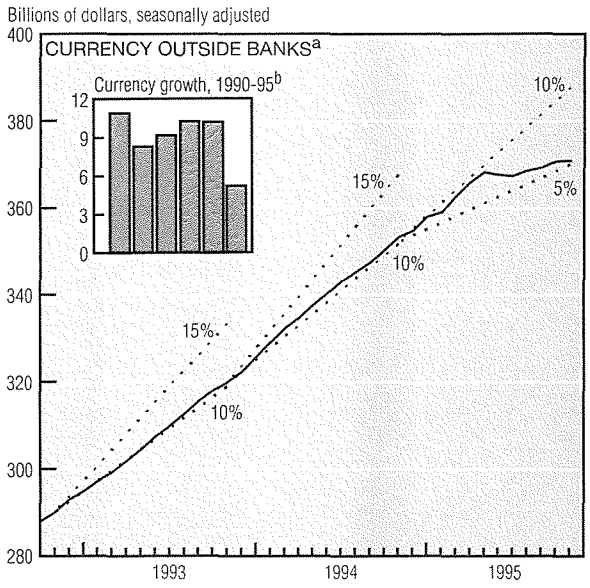

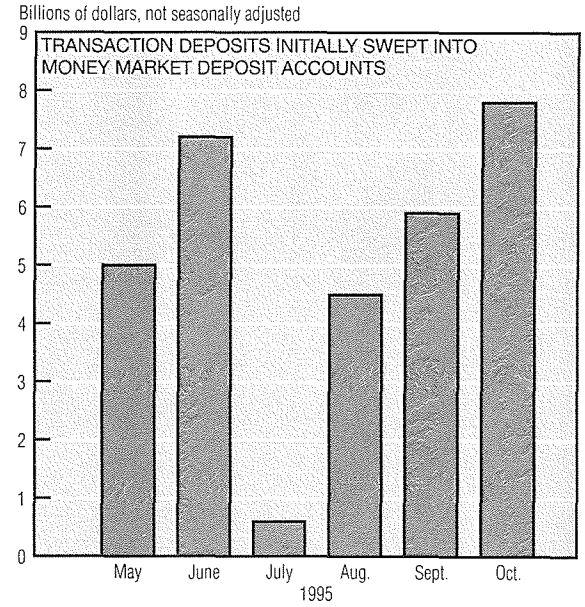

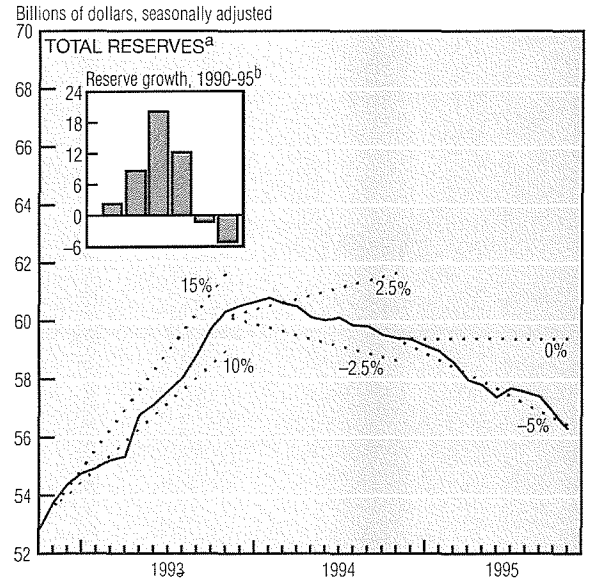

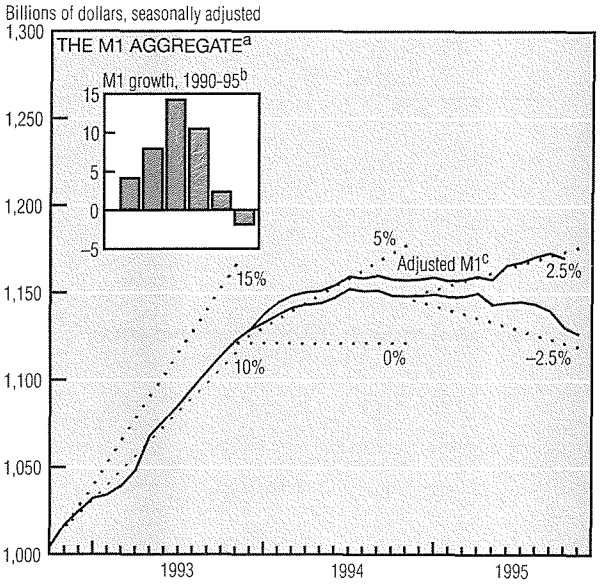

a. Last plot is estimated for November 1995.
b. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1995 is calculated on an estimated November over 1994:IVQ basis.
c. Adjusted for sweep accounts.
NOTE: Dotted lines represent growth ranges and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

have restrained the growth of the narrow money measures. The planned introduction of the redesigned $100 note may have had a significant effect on currency growth over the second half of 1995. Foreign holders of U.S. currency—many of whom have experienced unfavorable exchanges of their own currency—are concerned about the future acceptability of their dollar holdings, leading some to reduce this portion of their portfolio. Because it is estimated that almost 70% of all U.S. currency is held abroad, currency growth is believed to be highly sensitive to such concerns.

Another factor depressing the narrow aggregates is the widespread emergence of sweep accounts. Banks are initiating these programs to economize on their reserves, which earn no return for the bank. These arrangements sweep excess household checkable deposits, which are reservable, into money market deposit accounts, which are not reservable, thereby reducing a bank's required reserves. Over the past few months, depository institutions' intensified efforts to initiate sweep programs have led to sharp declines in checkable deposits and total reserves.

Because M1 comprises currency and checkable deposits, its growth has been significantly damped by these special factors. It is estimated that sweep accounts alone have depressed M1 growth more than 3% this year. Because the M2 aggregate includes money market deposit accounts, it is impervious to the development of sweep accounts.