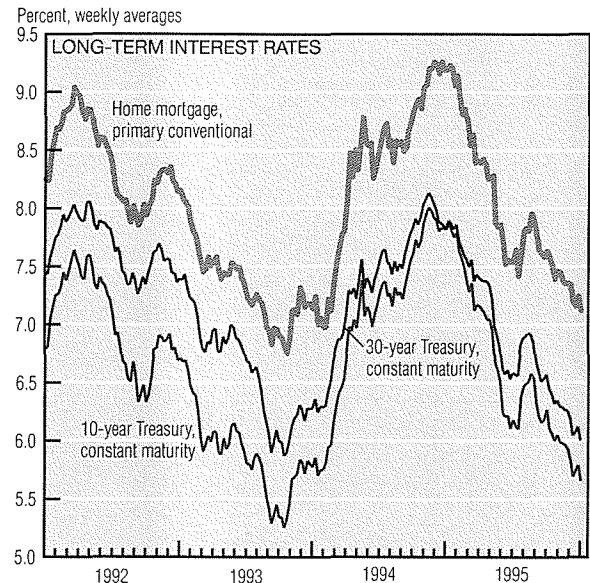
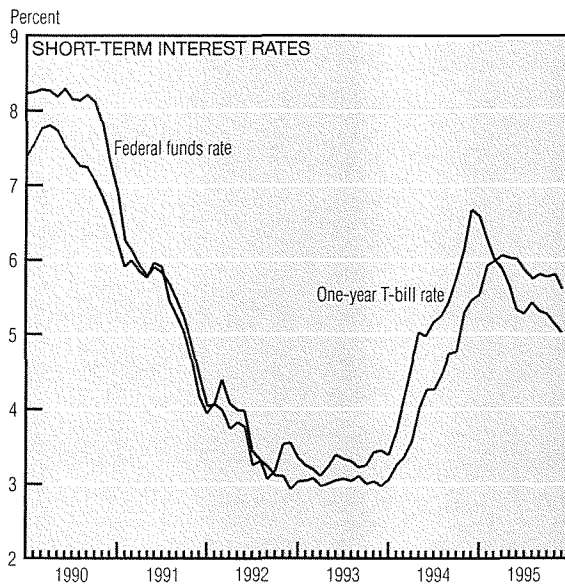
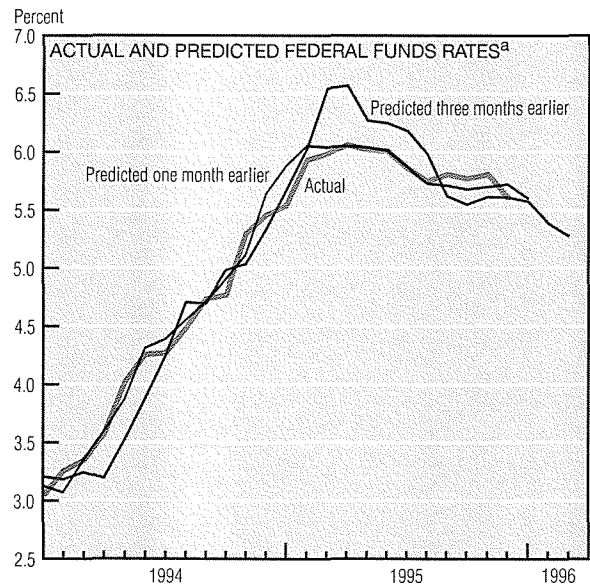
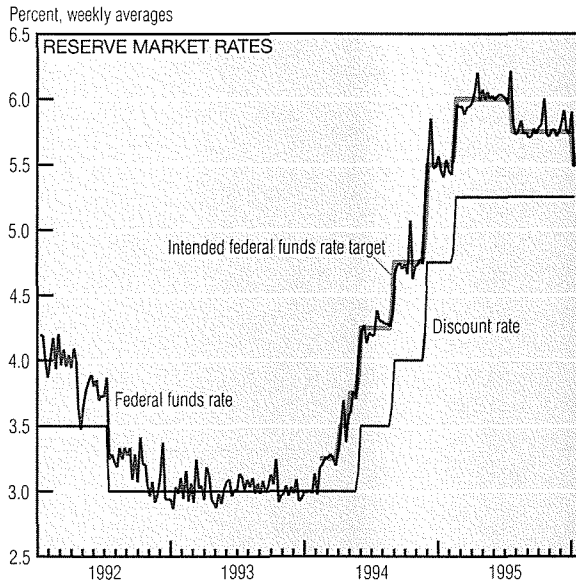


Monetary Policy



a. Predicted rates are federal funds futures.
 SOURCES: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

“Since the last easing of monetary policy in July, inflation has been somewhat more favorable than anticipated, and this result, along with an associated moderation in inflation expectations, warrants a modest easing in monetary conditions.”

This statement by Federal Reserve Chairman Greenspan accompanied the December 19 announcement that the Federal Open Market Committee (FOMC) had decided to lower the intended federal funds rate by 25 basis points, to 5.5%. It now seems likely that actual inflation in 1995, as measured by the

Consumer Price Index, will end the year below the 3% to 3½% range expected by the FOMC in July.

Although the timing of the recent policy move may have caught some market participants by surprise, a reduction in the fed funds rate had been anticipated for months. Indeed, since last year’s first rate cut in July, fed funds futures prices have implied an expectation of additional cuts. Another slight reduction in the intended fed funds rate is anticipated in early 1996. Since February, the rate on one-year Treasuries has been below the fed funds rate, also

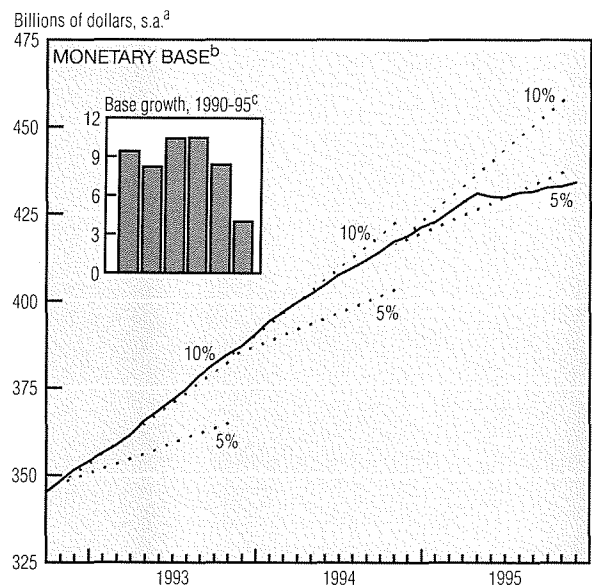
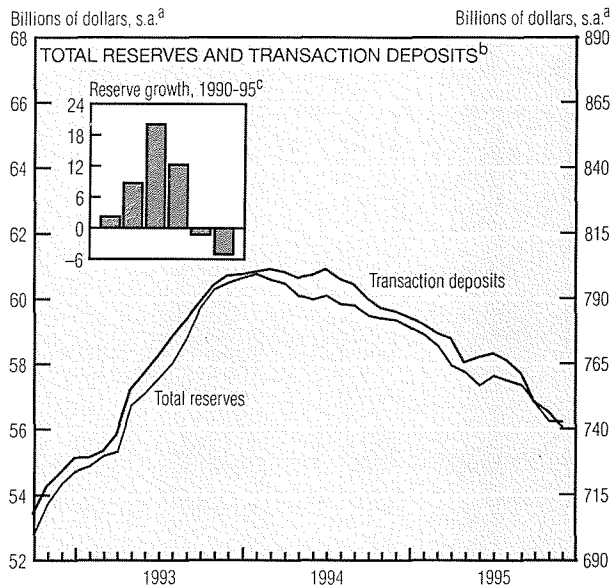
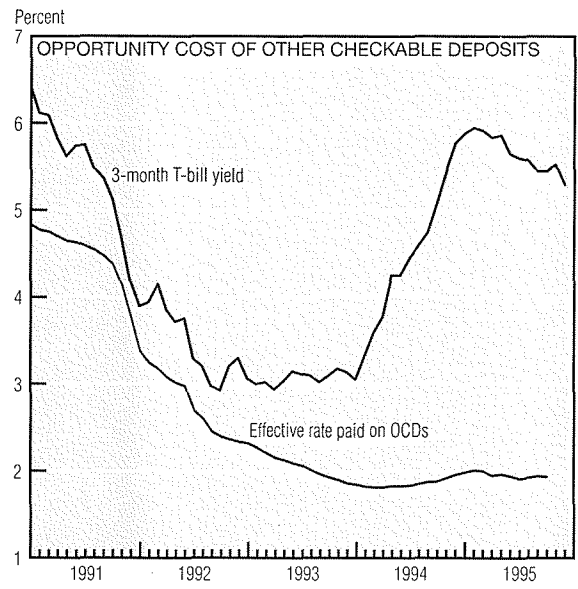
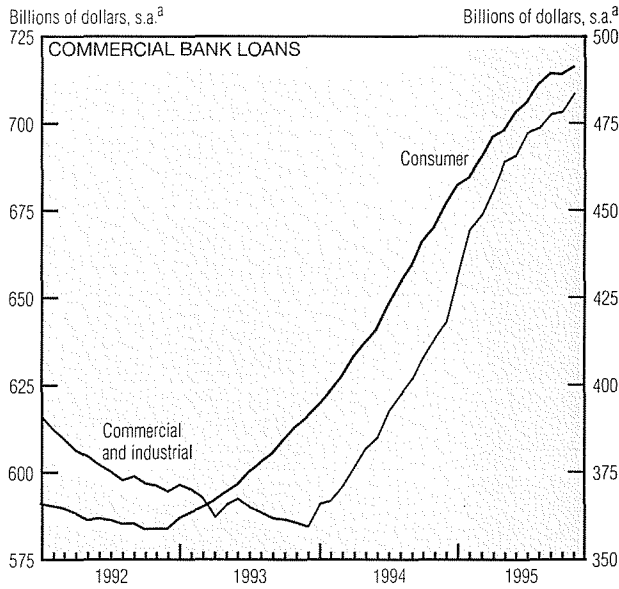
suggesting further policy actions throughout the coming year.

Declining inflation expectations contributed to at least part of the overall drop in interest rates last year. The 30-year Treasury bond fell below 6% in the final days of December, approaching the cyclical trough recorded in October 1993.

In the 26 months following that trough, long-term rates rose sharply, induced both by a strong economy that increased the rate of return on new business investment and by

(continued on next page)

Monetary Policy (cont.)



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

fears that inflationary pressures might lead to higher trend inflation. Since the peaks in capital market rates just over a year ago, inflation has been steady and business investment—while still strong—has moderated. Bank loans to consumers and businesses grew rapidly over this period, but have decelerated in recent months.

Banks for the most part financed their strong loan demand with non-deposit liabilities and large time de-

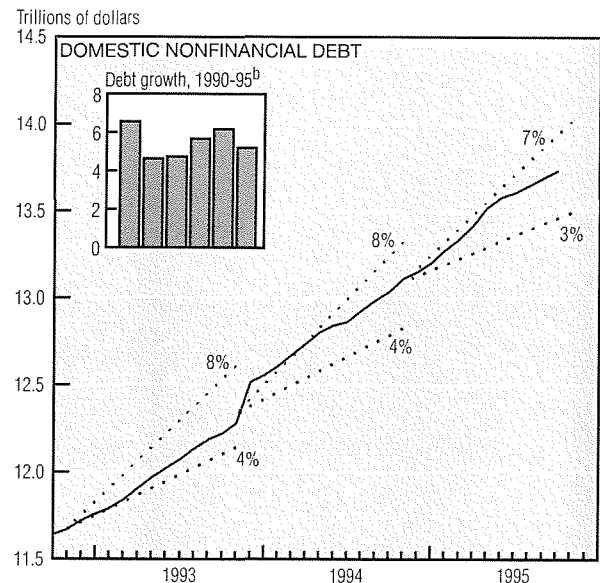
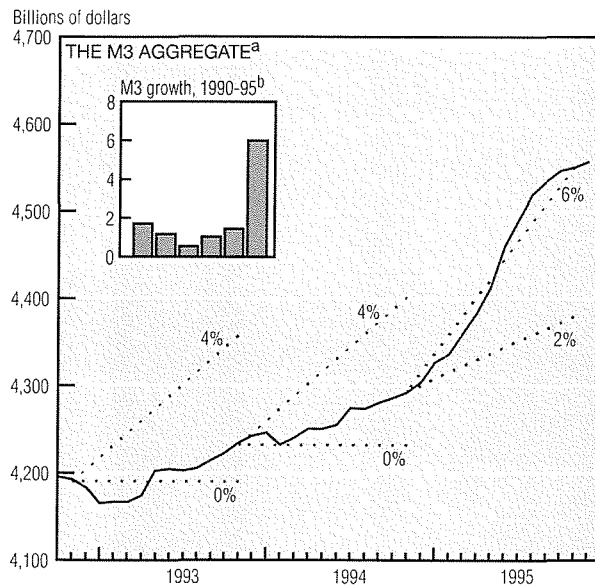
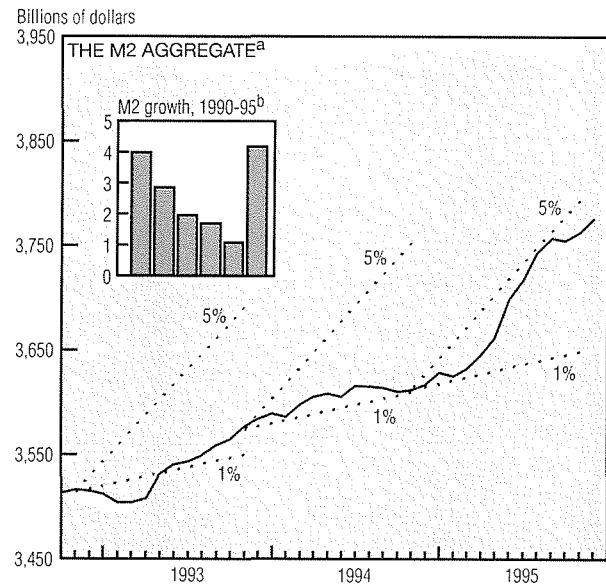
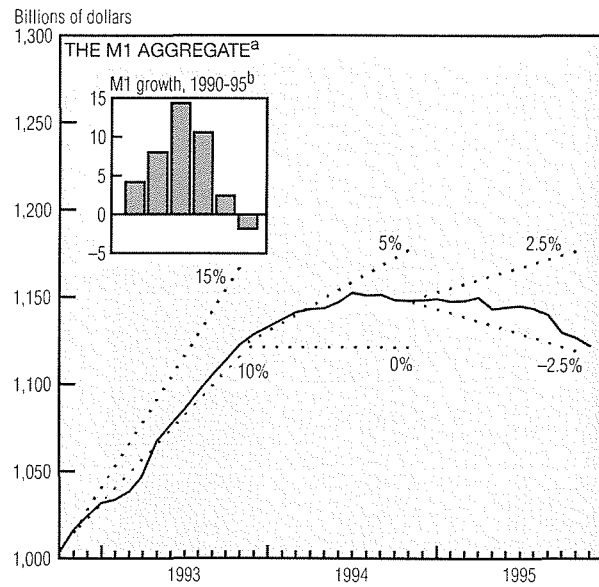
posits. As a consequence, pricing of other checkable deposits (OCDs) and money market deposit accounts (MMDAs) was not very aggressive. Indeed, the rate paid on OCDs hardly budged in the face of rising interest rates. Thus, OCD opportunity cost (measured here as the difference between the 3-month Treasury bill yield and the effective rate paid on OCDs) rose sharply, which in turn damped household demand for OCDs.

As short rates fell in 1995, so too

did the opportunity cost of OCDs and non-interest-bearing transaction deposits. Historical relationships suggested that transaction deposits would begin to grow during the year. This did not happen, largely because of the widespread implementation of sweep arrangements that economize on bank reserves. These arrangements “sweep” excess OCDs, which are reservable, into MMDAs, which are not reservable, thereby reducing a bank’s required reserves.

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Monetary Policy (cont.)



a. Last plot is estimated for December 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 1995:IVQ over 1994:IVQ basis for M1, M2, and M3, and on an October over 1994:IVQ basis for domestic nonfinancial debt.

NOTE: All data are seasonally adjusted. Dotted lines for M1 represent growth ranges and are for reference only. Dotted lines for M2, M3, and domestic nonfinancial debt are target ranges.

SOURCE: Board of Governors of the Federal Reserve System.

It is estimated that sweep accounts alone depressed transaction deposit growth by about $4\frac{1}{2}\%$ in 1995. Because transaction deposits are the only reservable deposit, the growth rate of total reserves was restrained almost proportionately. The monetary base, which comprises total reserves and currency held outside banks, was also affected. Its growth rate, however, is dominated by its currency component, which slowed sharply in the spring. Analysts believe that diminished cur-

rency growth is related to foreign investors' concerns about the exchangeability of their current holdings once the newly designed \$100 bill is introduced. It is also estimated that the M1 monetary aggregate, which includes both currency and transaction deposits, would have grown in 1995 in the absence of sweep accounts.

Despite considerable uncertainty about the future relationships of money and debt to fundamental policy objectives, the FOMC continues to set growth ranges for M2, M3,

and domestic nonfinancial debt. The Humphrey-Hawkins Act of 1978 mandates that the Federal Reserve report these ranges to the U.S. Congress. It is perhaps ironic that although little attention is paid to these measures, they all ended the year within their specified range. M2, which includes both OCDs and MMDAs, was impervious to the implementation of sweep arrangements. The strength in M3 largely reflected banks' tendency to finance loan growth by issuing large CDs.