

SOURCES: Board of Governors of the Federal Reserve System; the Chicago Board of Trade; and *Bank Rate Monitor*, various issues.

Since its February meeting, the Federal Open Market Committee (FOMC) has chosen to maintain the federal funds rate near an intended level of 5¼%. The funds rate (the interest rate banks pay on overnight loans to each other) is an anchor for other short-term rates. Between June 1995 and February 1996, the FOMC voted to lower the intended funds rate in three increments of 25 basis points each. The yield on one-year Treasuries fell about two percentage

points from its January 1995 peak, while the yield on the three-month Treasury bill dropped to below 5%. That these yields had fallen below the overnight rate suggested an expectation of further funds-rate cuts.

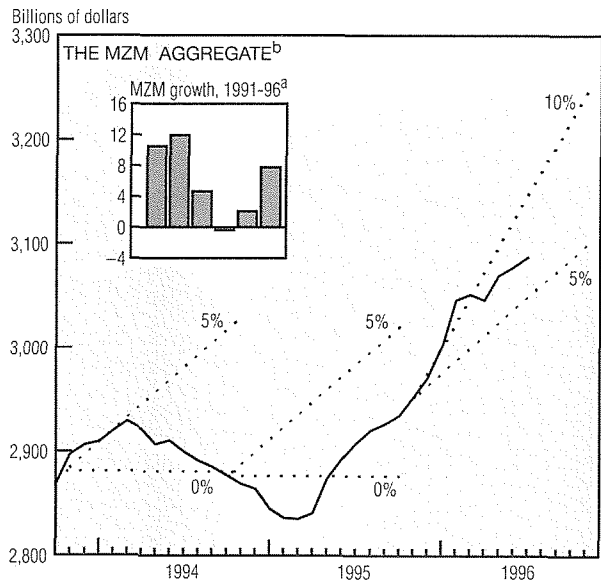
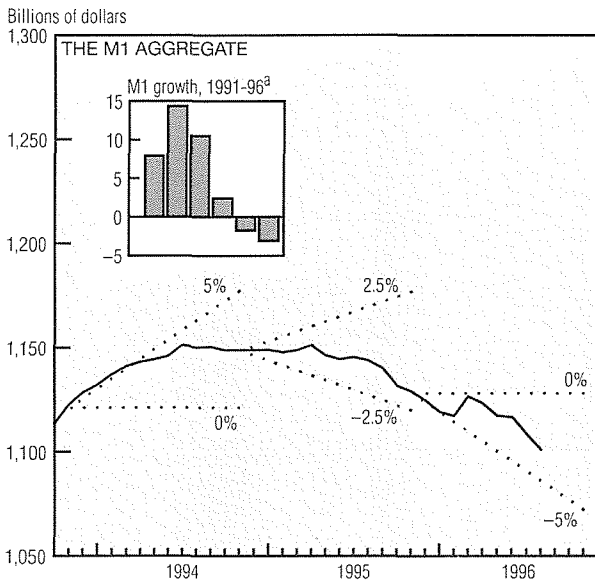
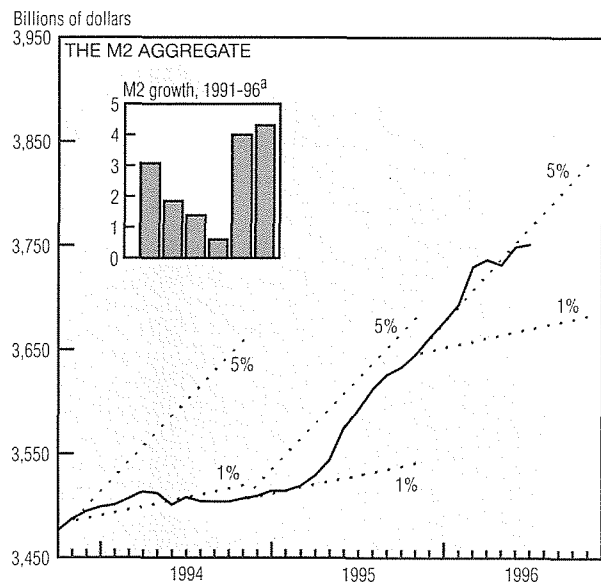
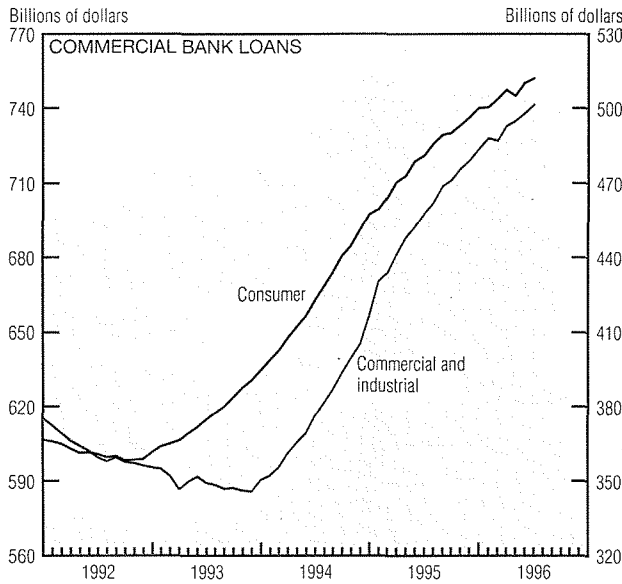
Early this year, however, the one-year yield changed direction quickly as market sentiment reversed. By midyear, money market yields imparted an expectation that the next deliberate policy action would result in a funds-rate increase. Such an expectation was also evident in the fed

funds futures market. The implicit yields on these instruments in late June indicated an expectation that the funds rate would increase at least 25 basis points by early fall. As the summer progressed, however, the expected trajectory shifted out by more than two months.

Interest rates paid on certificates of deposit (CDs) and money market deposit accounts (MMDAs) respond sluggishly to market conditions. As a

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Monetary Policy (cont.)



a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1996 is calculated on an estimated August over 1995: IVQ basis.
 b. MZM is an alternative measure of money that includes M2 plus institutional money market mutual funds less small time deposits.
 NOTE: All data are seasonally adjusted. Last plot is estimated for August 1996. Dotted lines represent growth ranges and are for reference only.
 SOURCE: Board of Governors of the Federal Reserve System.

consequence, the opportunity cost of a given deposit (typically measured as the spread between the interest rate paid on a Treasury bill and that paid on the deposit) tends to rise and fall with market rates.

Commercial bank loan growth has slowed in recent months. Nevertheless, both consumer and commercial and industrial credit continue to expand at a moderate pace. With lessened credit demands, banks are unlikely to raise deposit rates quickly in response to a firming in

market conditions. Any rise in opportunity cost would probably induce a further slowdown in the monetary aggregates.

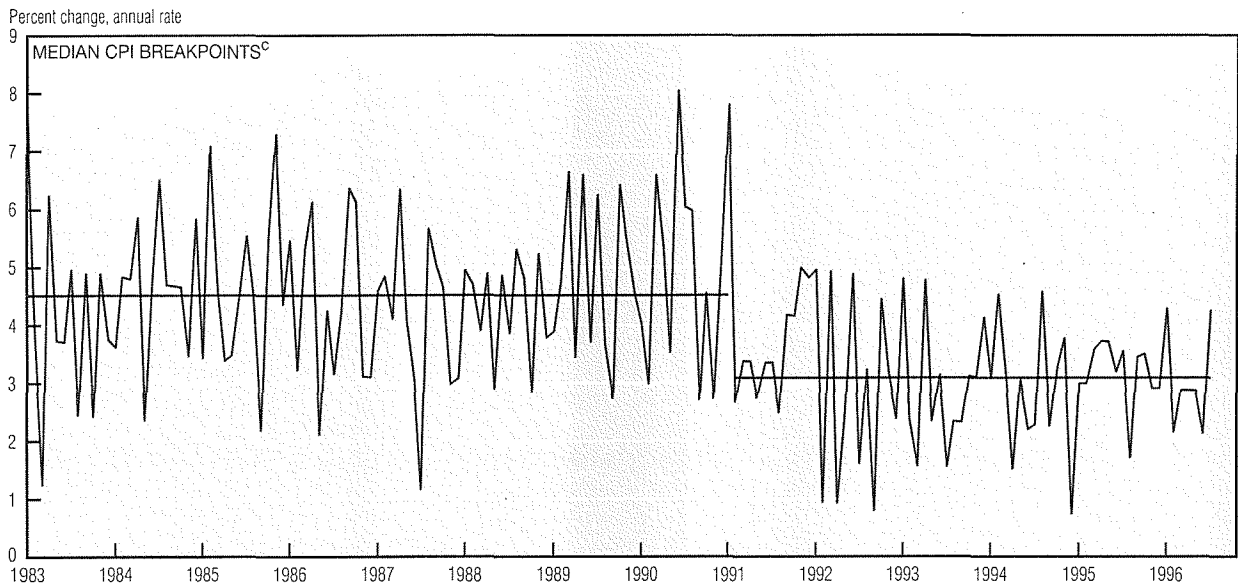
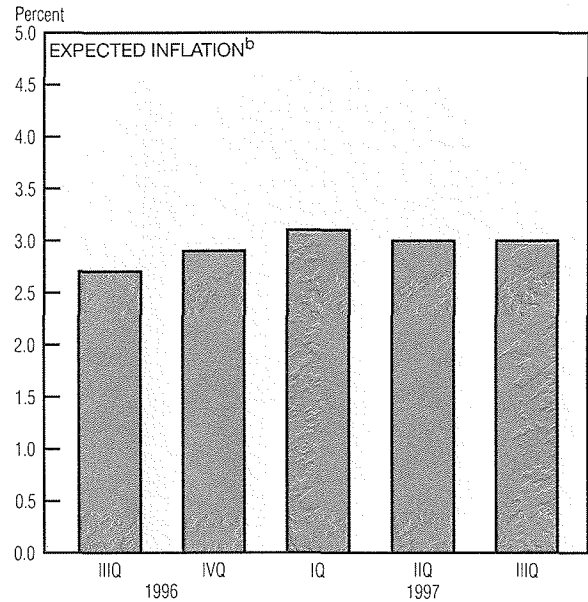
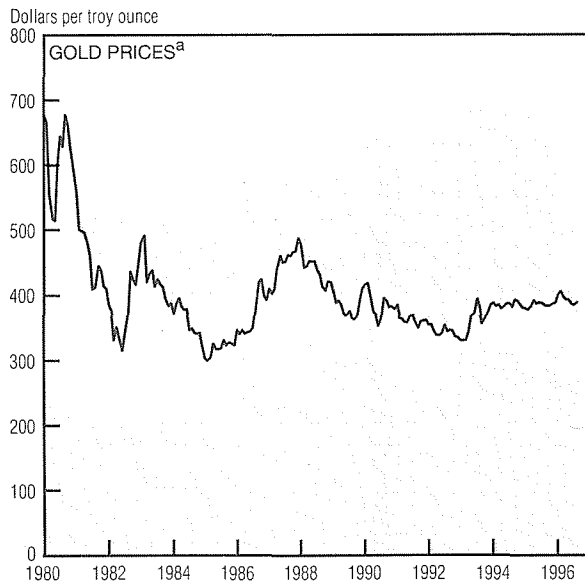
The response of money growth to interest-rate changes typically occurs with a lag. Indeed, M2 growth slowed in the second quarter only after the effects of the previous rate reductions wore off. The aggregate appears to be responding more consistently with its historical pattern, after behaving atypically in the early 1990s. Federal Reserve Chairman

Alan Greenspan noted in his recent Congressional testimony that the relationship linking M2 to its opportunity cost has "reasserted itself."

M1 continues to fall. It is widely understood that weakness in this aggregate is largely related to the implementation of sweep accounts, which automatically transfer funds from other checkable deposits (OCDs) to MMDAs, when balances allow. It is believed that M1 would be increasing were it not for the proliferation of sweep accounts.

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Monetary Policy (cont.)



a. Handy and Harman base price, New York.

b. Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia.

c. Horizontal lines represent trends.

SOURCES: DRI/McGraw-Hill; the Federal Reserve Bank of Philadelphia; and the Federal Reserve Bank of Cleveland.

The MZM measure of money comprises instruments that have zero maturity and hence are redeemable at par on demand. Because this aggregate includes both OCDs and MMDAs, it is immune to the effects of sweep accounts. MZM growth has moderated from its rapid pace earlier this year. The recent modest increase in market interest rates is expected to slow MZM's pace even further.

Since early 1991, core inflation (as measured by the median CPI) has

been in the neighborhood of 3%. Facing signs of inflationary pressures in early 1994, the FOMC headed off the threat with a series of actions that initially led to a period of rising interest rates and slowing money growth.

As inflationary pressures subsided in 1995, the FOMC took actions that led to falling interest rates. The series of funds-rate reductions, although inducing an acceleration in money growth, were modest. Consequently, neither M2 nor MZM growth has persisted at excessive rates.

The price of gold has historically been one of the most sensitive indicators of inflation. Although gold exceeded \$400 per ounce in February, its price has receded substantially since then, suggesting that inflation fears are contained. Moreover, survey data on inflation expectations corroborate a stable outlook for the price level. This stability, however, hinges on the belief that the FOMC will act swiftly to head off any potential for accelerating inflation.