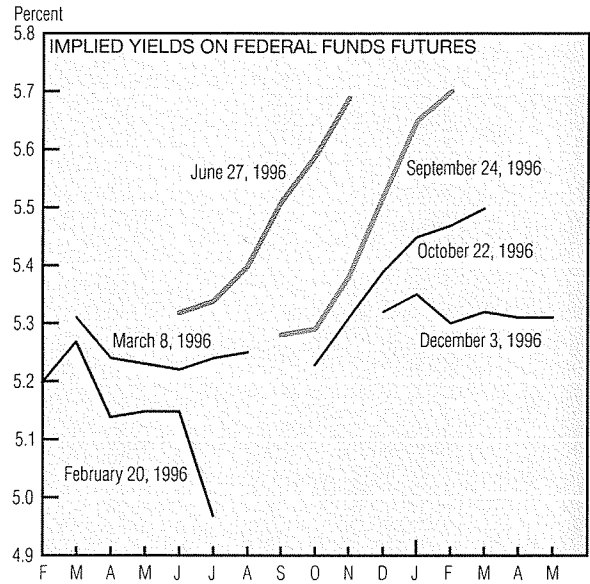
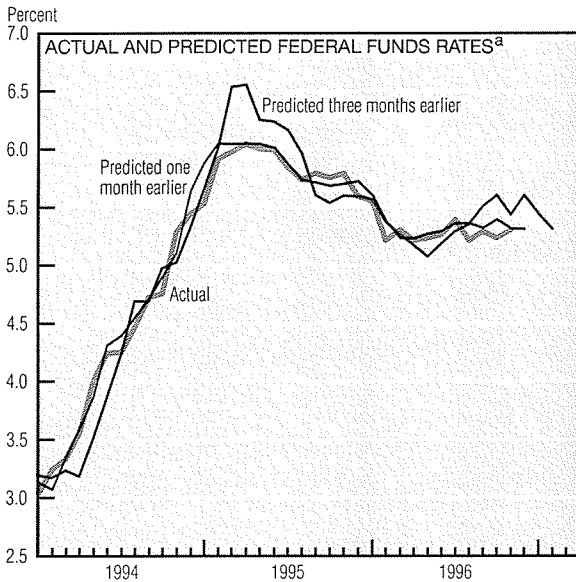
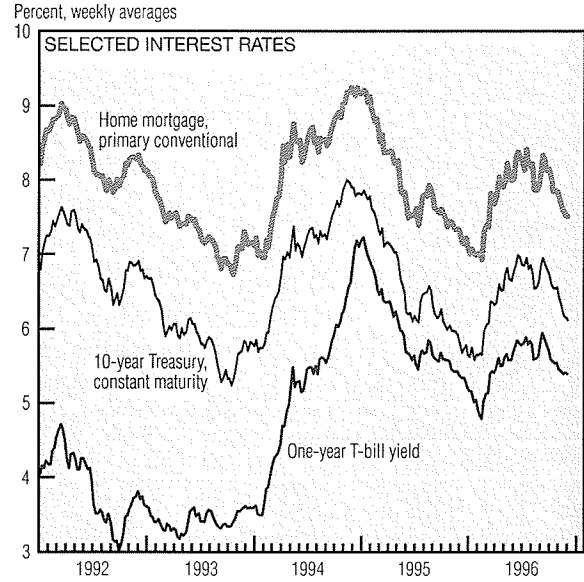
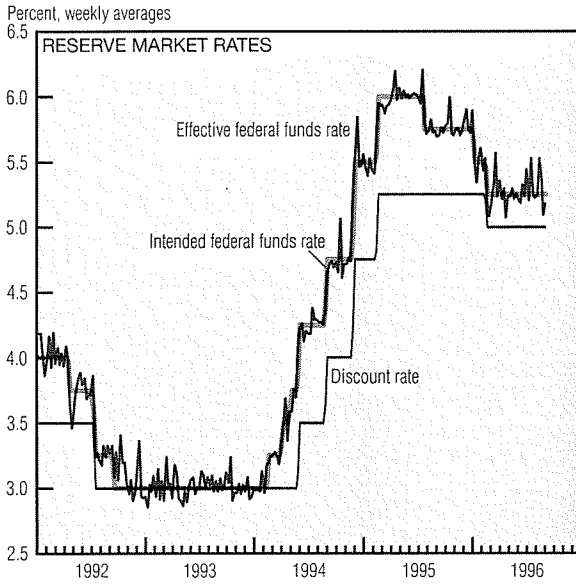


Monetary Policy



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

It has been more than 10 months since the Federal Open Market Committee (FOMC) last changed the intended federal funds rate. That action, a 25-basis-point cut, followed an equal reduction at the group's December meeting. Over the balance of 1996, market expectations vacillated regarding the direction of the next policy move.

The one-year Treasury-bill yield moved up sharply early in the year as prospects for further rate cuts diminished and ultimately reversed. Longer-term rates rose even more dramatically, then swung substantially over the summer months as

market commentary revealed a growing sentiment for a policy tightening. Home mortgage rates rose almost 150 basis points from early 1996 to early summer. Since then, all rates have receded somewhat.

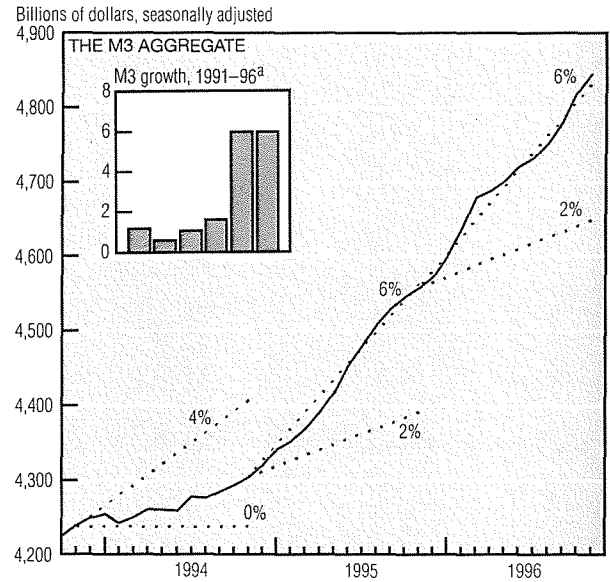
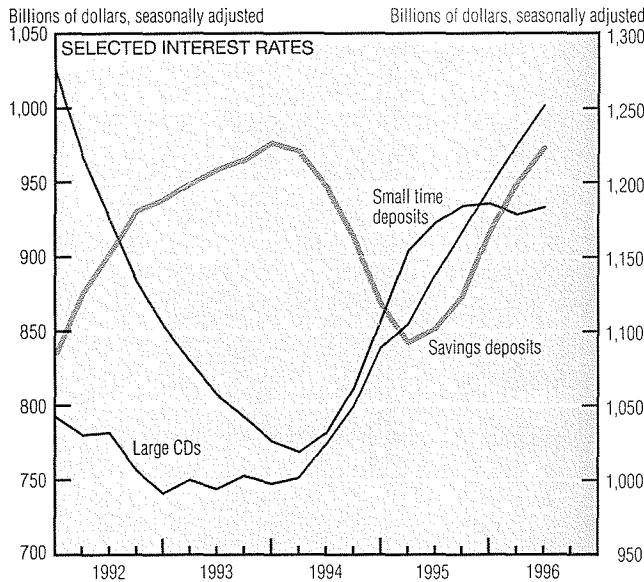
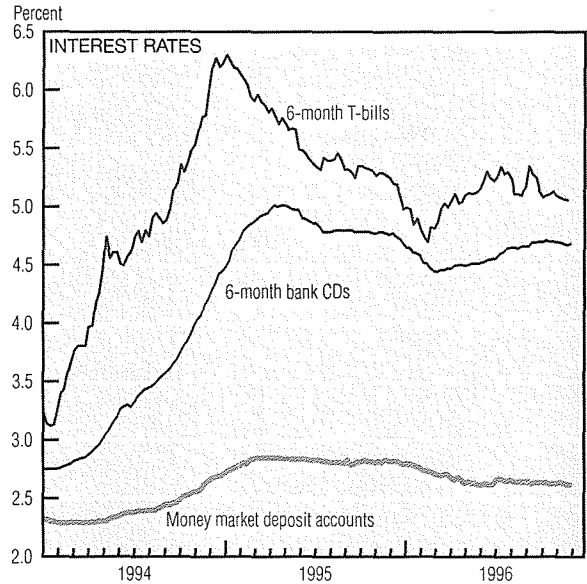
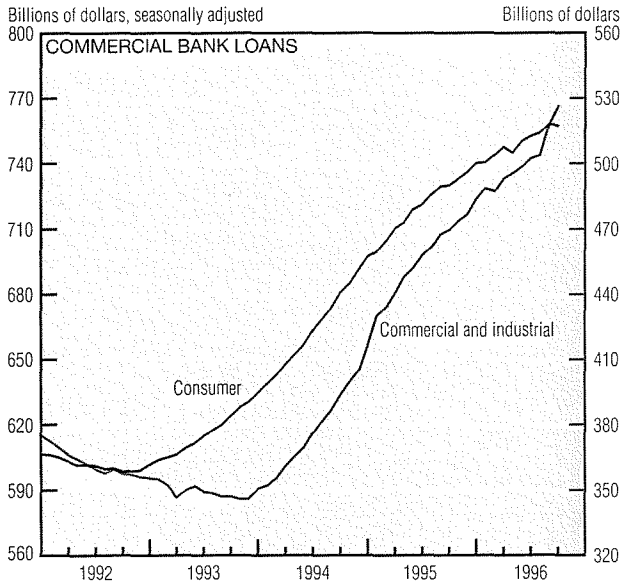
Most futures contracts are drawn on commodities or financial instruments whose price or yield is determined in competitive markets. The federal funds rate, on the other hand, is essentially determined by a deliberative decision of the FOMC. The fed funds futures market is thus a place where one can place a bet as to what future monetary policy will be. The implied yields of these fu-

tures prices serve as a reasonably unbiased predictor over horizons of three months or less.

By early March, the implied futures yields revealed that expectations of another rate cut had vanished. At midyear, the economy appeared to be stronger than expected, and these yields indicated that a fed funds rate increase was imminent. Expectations of a change in policy climaxed right before the September meeting. Recently, the implied yields have indicated that participants in this market do not expect a policy action before spring.

(continued on next page)

Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1996 is calculated on a November over 1995:IVQ basis.
 NOTE: Dotted lines represent growth ranges and are for reference only.
 SOURCES: Board of Governors of the Federal Reserve System; and *Bank Rate Monitor*, various issues.

Given the environment of continued economic expansion with low or moderate inflation, commercial banks have faced relatively strong demand for commercial and industrial (C&I) loans. In September and October, C&I loans shot up at an annual rate of more than 19%, compared with 8% over the previous year. Preliminary data for November reveal that C&I loan growth is moderating.

Consumer loans at commercial banks have been relatively flat in recent months. Apparently, consumers are becoming more cautious about

the amount of additional credit they are willing to take on. While much attention has been given to increased delinquency rates, the state of consumer credit at commercial banks is not alarming. Nevertheless, continued moderation in consumer loan growth will help assuage fears about credit quality.

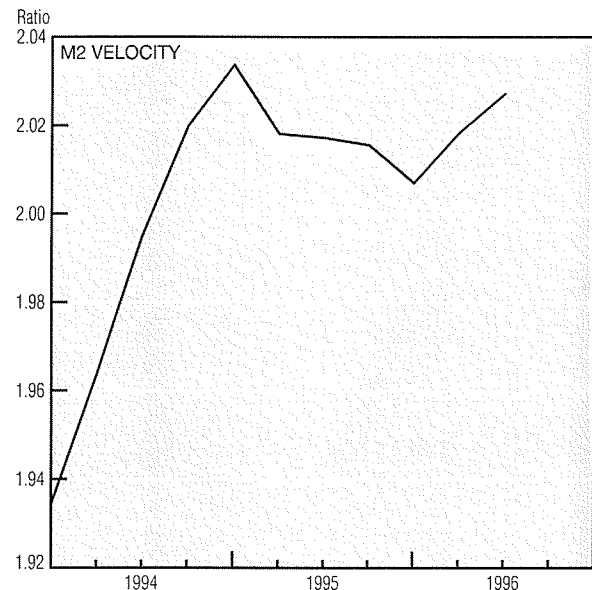
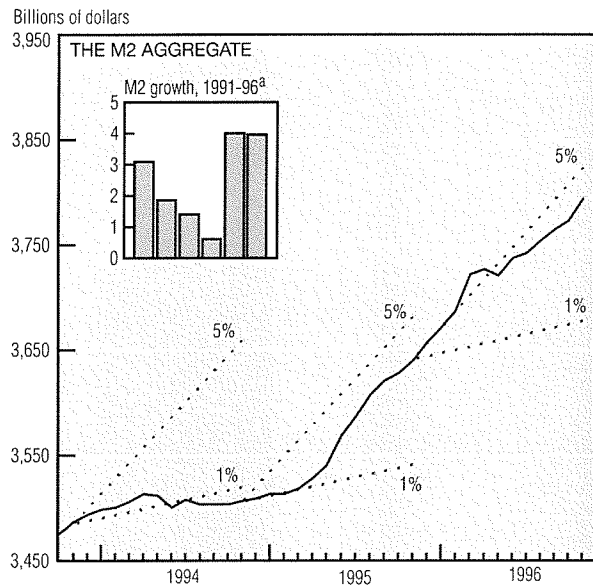
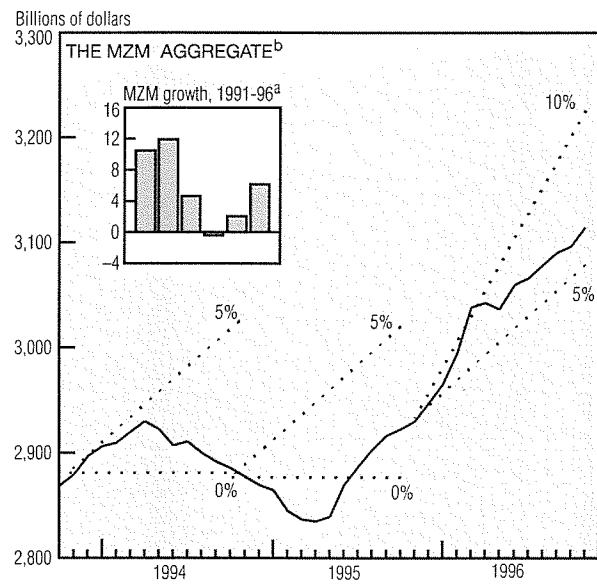
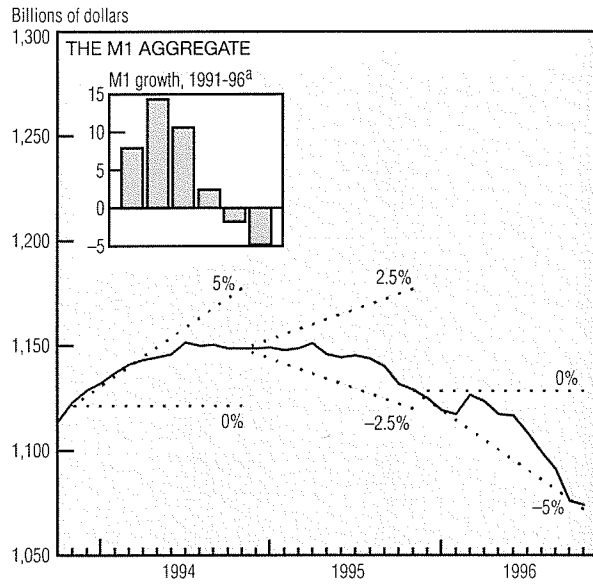
Since mid-1994, banks have tended to finance much of their loan growth by issuing large certificates of deposit (CDs), which have increased at double-digit rates throughout the period. The rates paid on these deposits are determined in the CD market. Persistently strong gains in large

CDs have been the major source of strength in M3, which for two years has consistently run at or above the upper end of its growth ranges.

Unlike the case with large CDs, banks post the rates they are willing to pay for small time deposits and money market deposit accounts (MMDAs). If posted rates are competitive, these instruments attract funds. During 1996, the rates offered by banks on small time deposits have generally been attractive enough only to maintain the level of these deposits.

(continued on next page)

Monetary Policy (cont.)



a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1996 is calculated on a November over 1995:IVQ basis.

b. MZM is an alternative measure of money that is equal to M2 plus institutional money market funds less small time deposits.

NOTE: All data are seasonally adjusted. Dotted lines represent growth ranges and are for reference only.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

MMDAs have grown even though rates paid on these deposits declined in the face of rising short-term market rates. This growth largely reflects the impact of the implementation of sweep accounts, which banks have initiated over the past few years to economize on reserve balances. These arrangements "sweep" excess household checkable deposits, which are reservable, into MMDAs, which are not. Thus, the implementation of these arrangements accounts for the unexplained strength in MMDAs and the weakness in M1, which includes checking accounts but not MMDAs.

The impact of sweeps washes out in broader aggregates such as M2 and MZM, which include both instruments. The MZM measure of money comprises instruments that have zero maturity and hence are redeemable at par on demand. As short-term market rates began to rise relative to rates paid on MZM deposits, MZM growth moderated from its rapid pace earlier in the year. In light of the recent stability of short-term rates, MZM is expected to continue expanding near its recent moderate pace.

M2 growth also slowed in response to the turnaround in interest

rates. This aggregate appears to be responding more consistently with its historical pattern, after behaving atypically in the early 1990s. It appears as though M2 velocity (the ratio of nominal GDP to M2) has stabilized at a new higher level. As Federal Reserve Chairman Alan Greenspan noted during his midyear congressional testimony, the relationship linking M2 to its opportunity cost has "reasserted itself." Nevertheless, given the limited experience and the contained nature of inflation, it seems unlikely that M2 will fully regain its lost status any time soon.