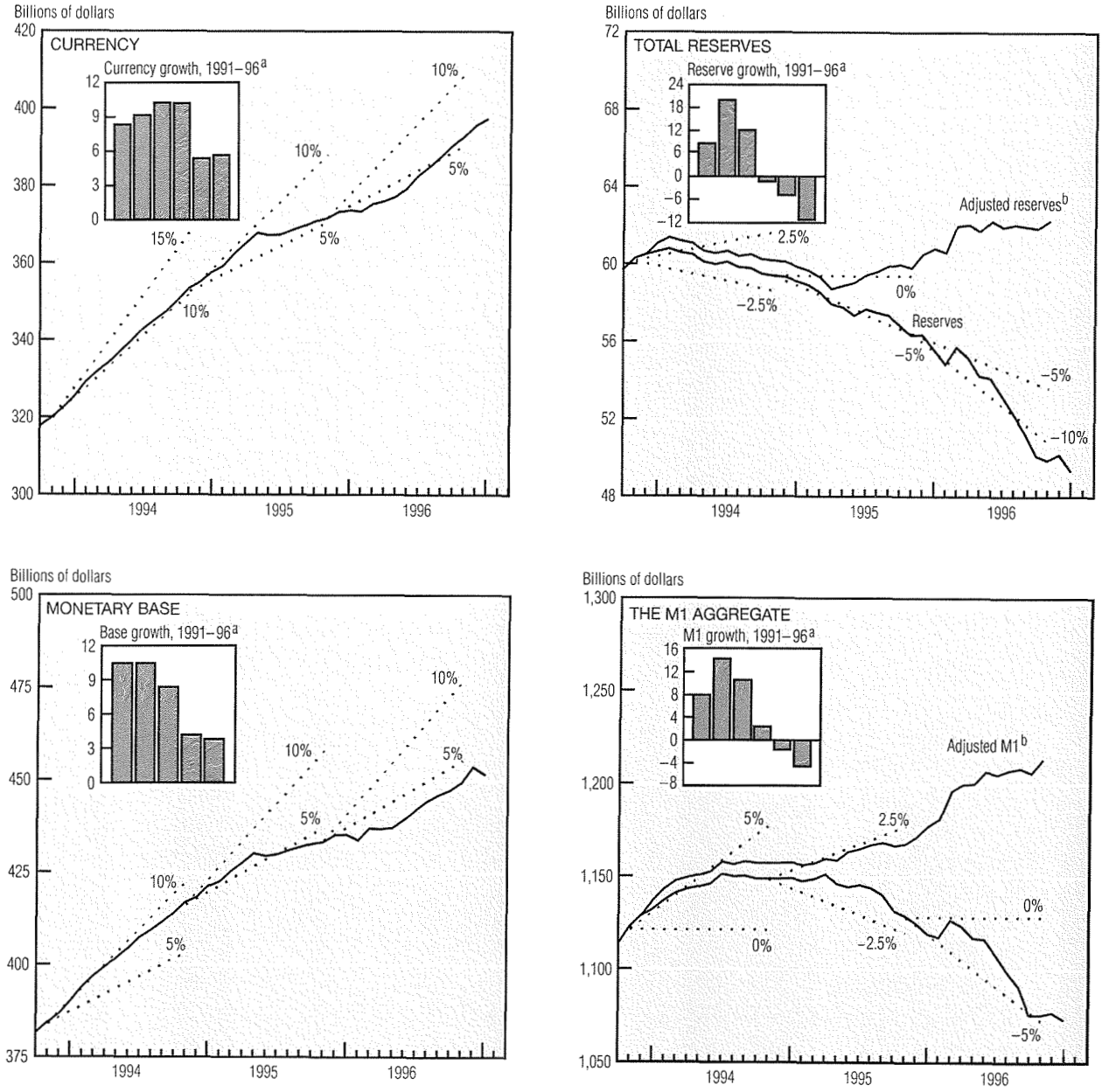
Monetary Policy



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.
b. Adjusted for sweep accounts.
NOTE: All data are seasonally adjusted. Last plot is estimated for January 1997. Dotted lines represent growth ranges and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

Every narrow money measure except currency fell in January. Currency grew 4.7%, which was slightly slower than its 1996 average rate of 5.7%. Unadjusted total reserves fell 19.4%, substantially more than last year's annual percentage loss of 11.4%. The monetary base declined 5.3% after rising 3.8% in 1996. The 4.5% drop in unadjusted M1 is in line with last year's 4.7% decrease.

Both M1 and total reserves were beginning to moderate at the end of 1996, convincing some analysts that sweep accounts were becoming saturated. These accounts, initiated in late 1993 as a way for banks to economize on their reserves, "sweep" excess household checkable deposits, which are reservable, into money market deposit accounts, which are not. Sweep accounts are believed to be responsible for the sharp declines in M1 and total reserves in recent years; however, even when these measures are adjusted for sweeps, they still show anemic growth.

The usefulness of available sweep account data is limited, because depositories are not required to disclose the size of their programs. This means that sweep account activity can be estimated only by using the daily-average effect of new sweep programs on the monthly average

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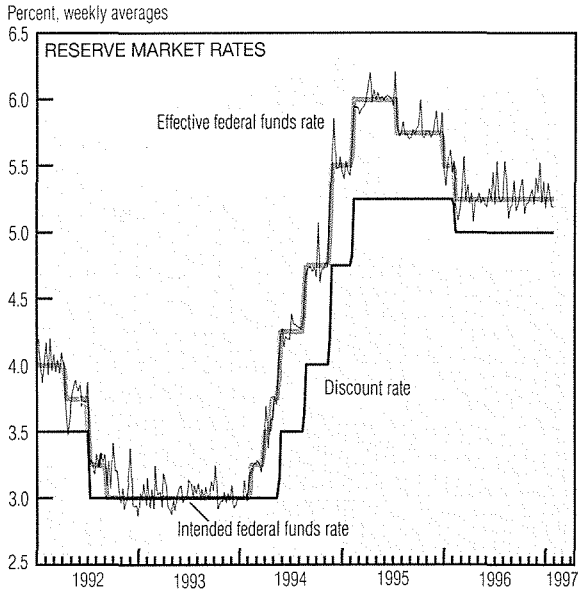
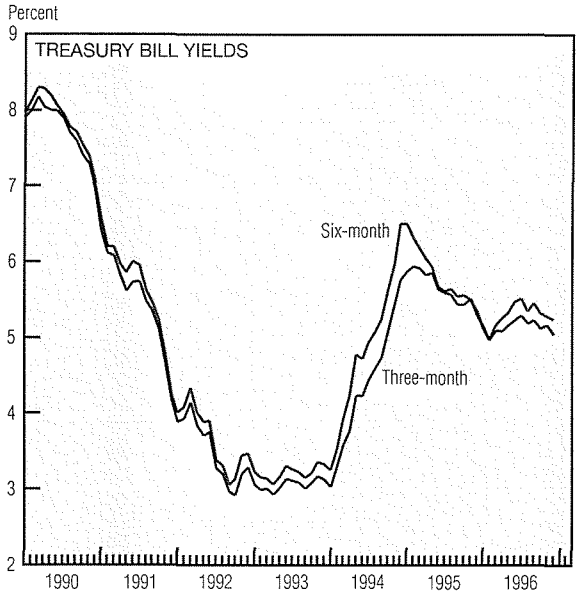
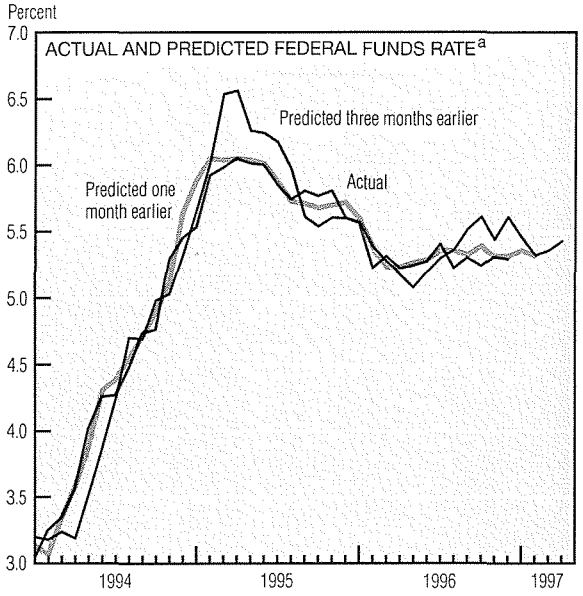
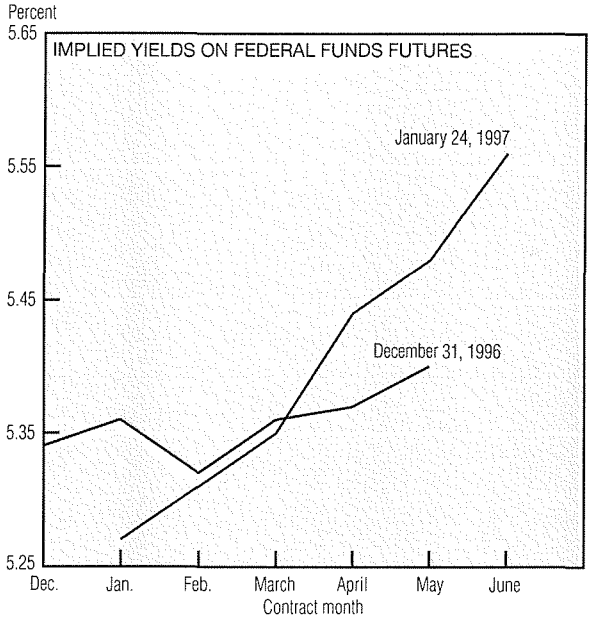
Monetary Policy (cont.)









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

level of other checkable deposits.

The Federal Open Market Committee (FOMC) reconvened in early February and reportedly took no action on the federal funds rate. A full year has passed since policymakers approved a reduction (25 basis points). Since that time, the economy has continued to grow at a moderate pace and inflationary pressures have been kept in check. Although the funds rate has remained constant, yields on short-term Treasury securities have tapered off in recent months. Current T-bill yields are 5.0% on the three-month bill and 5.2% on the six-month. Although short-term yields are below their historical averages, they are about 2% above 1993 levels.

Federal Reserve Chairman Alan Greenspan appeared satisfied with the current state of the economy when he testified before the Senate Budget Committee in January, but he observed that if the U.S. labor market continues in its current state, workers are likely to start demanding higher wages. The federal funds futures market, which reflects participants' expectations of future FOMC actions, seems to concur with the Chairman, and has built a moderate increase into the funds rate by late in the second quarter of 1997. This is a distinct change from last December, when market participants were

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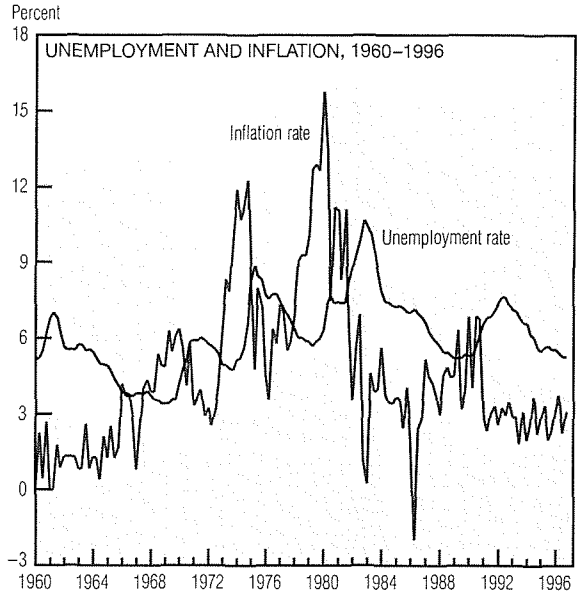

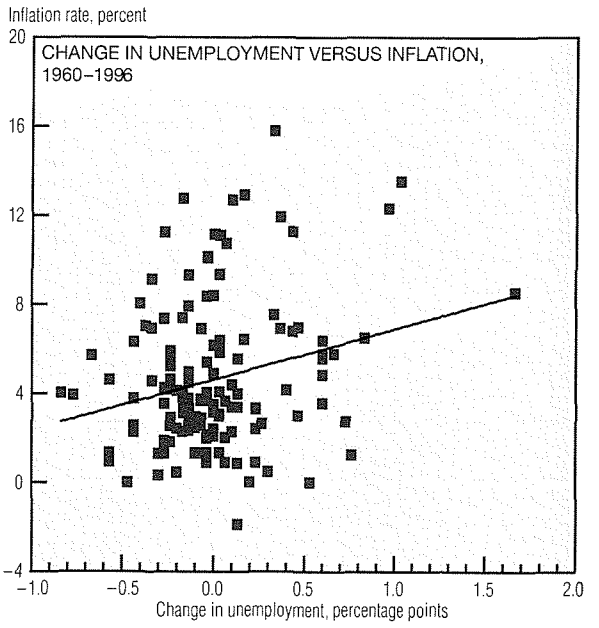

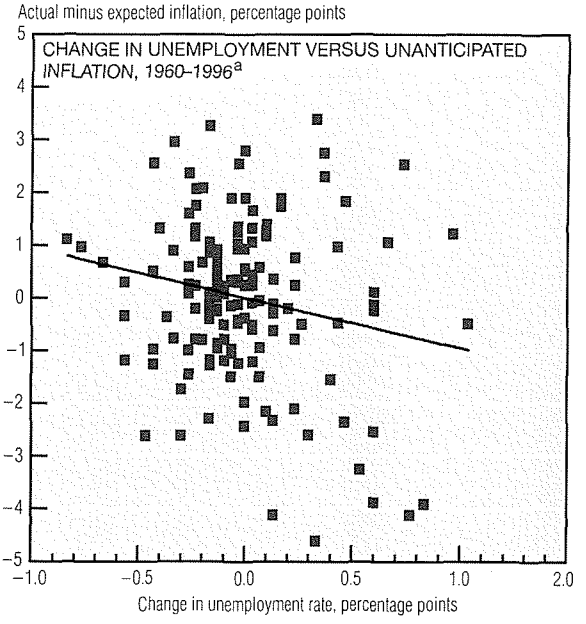

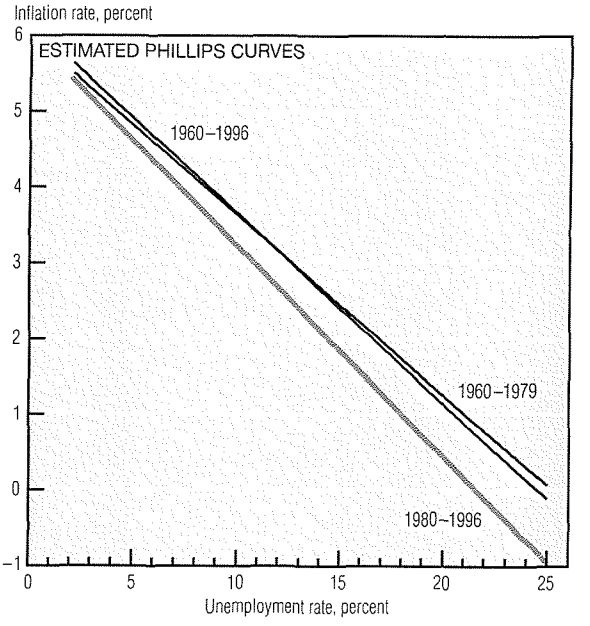

a. Unanticipated inflation is the difference between actual inflation and its expected value, where expected inflation is based on past inflation rates.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and the Federal Reserve Bank of Cleveland.

expecting policy to remain neutral until May.

The unemployment rate is currently 5.4%, well below what many analysts consider consistent with low inflation. They contend that rising unemployment leads to lower inflation and falling unemployment leads to higher inflation. Although this relationship (called the "Phillips curve") is thought to be one of the most reliable in macroeconomics, the current prolonged period of low inflation and low unemployment raises doubts about its validity.

Indeed, in examining the data, one might at first believe that a slight positive relationship exists, a view that is confirmed when one plots the inflation rate against the change in the unemployment rate. Analysts generally resolve the apparent conflict between the Phillips curve and the data by focusing on the change in unemployment and the deviation of inflation from the level expected by the market. With this modification, the data more readily reveal a negative correlation between price changes and unemployment.

Clearly, the relationship between unemployment and inflation should be regarded with some skepticism. After all, a negative correlation is one thing, but a stable relationship is quite another. Evidence shows that simple estimates of the Phillips curve based on available data may shift over time. Thus, although the Phillips curve remains a focal point for policy discussions, a cautious application seems warranted.