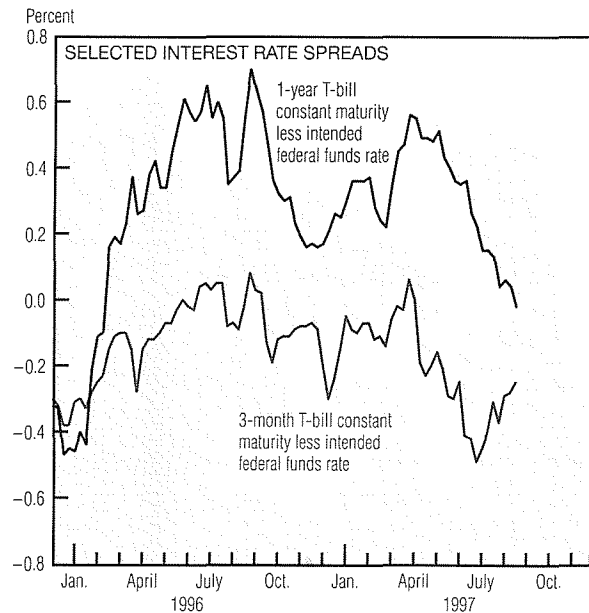
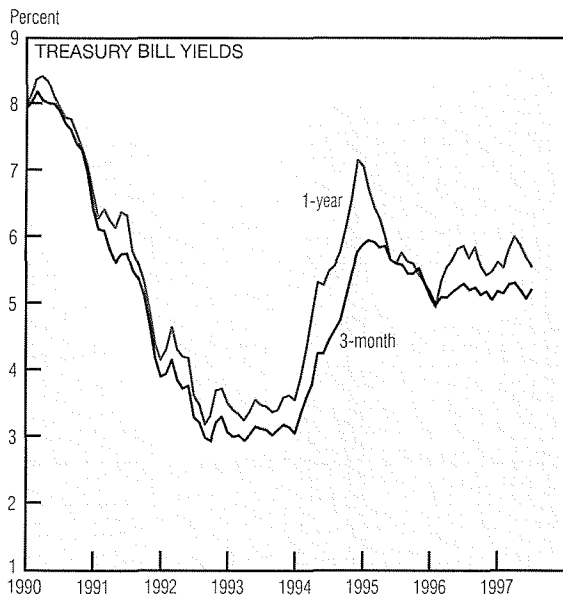
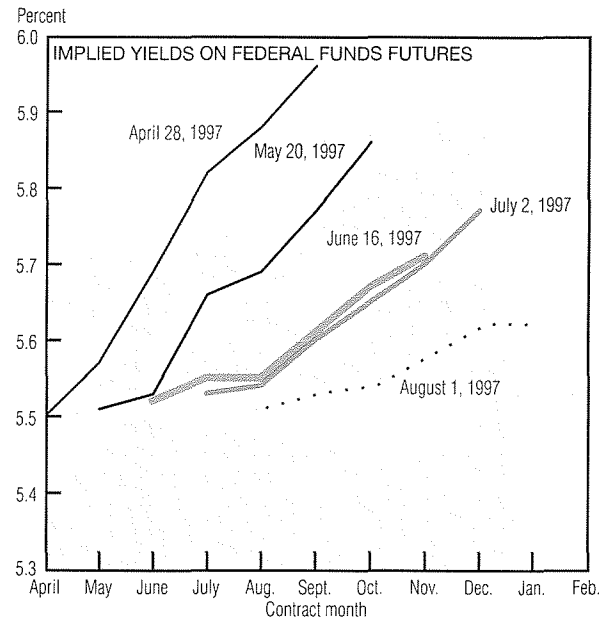
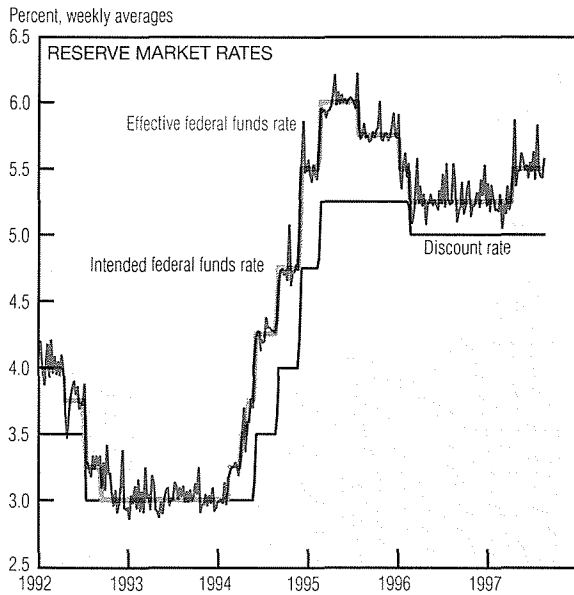


Monetary Policy



SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

The semiannual Federal Reserve System monetary policy testimony to Congress, delivered by Chairman Greenspan on July 22, along with the Board of Governors' report, summarizes the Fed's view of current economic conditions and monetary policy as well as its outlook for economic performance through 1998.

Chairman Greenspan reported that "the recent performance of the economy, characterized by strong growth and low inflation, has been exceptional—and better than most anticipated." He noted that the Board, as well as many observers,

have been puzzled by the combination of an economy operating at high levels of real activity and low inflation.

Since the February report on monetary policy, the central tendency of forecasts by the Board of Governors and the Reserve Bank presidents has increased to 3%–3¼% for real output growth, and has fallen to 2¼%–2½% for inflation. The central tendency forecasts for 1998 are 2%–2½% for real GDP and 2½%–3% for inflation.

The intended federal funds rate has remained at 5½% since late March, when the Federal Open

Market Committee (FOMC) raised it from 5¼% because, as the Board report explained, "the Committee was concerned about the risk that if the outsized gains in real output continued, pressures on costs and prices would emerge that could eventually undermine the expansion."

While the federal funds rate has been steady, interest rates have fallen. Since late April, the 1-year Treasury constant maturity rate has fallen more than 50 basis points, while the 3-month constant maturity rate has declined 9 basis points. Some perceive an implicit tightening

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Monetary Policy (cont.)

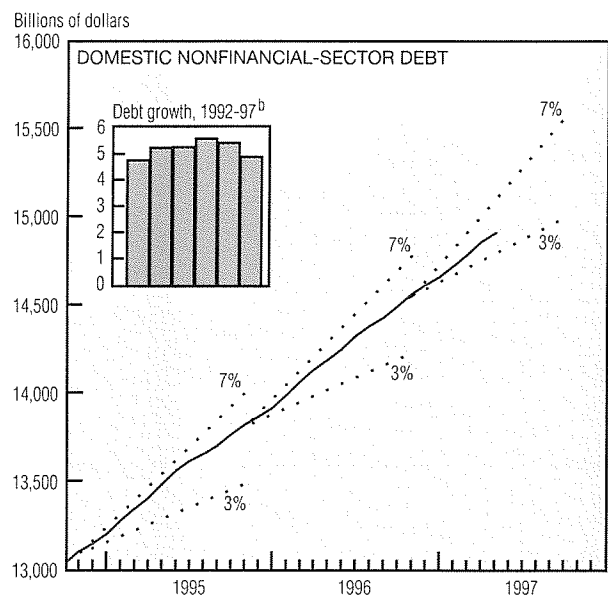
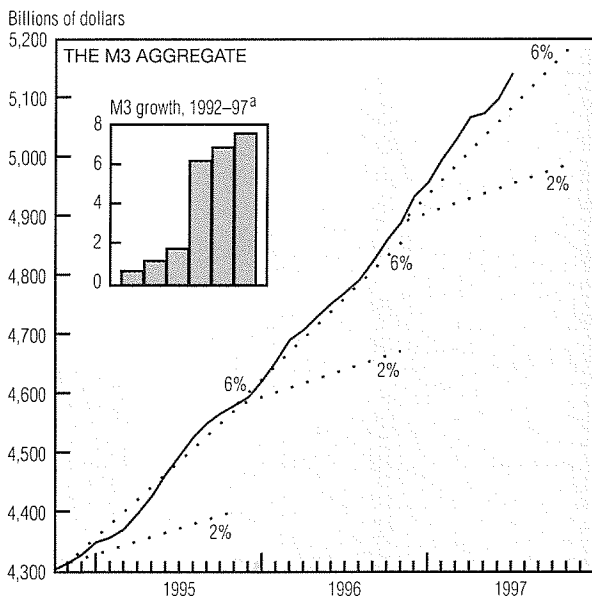
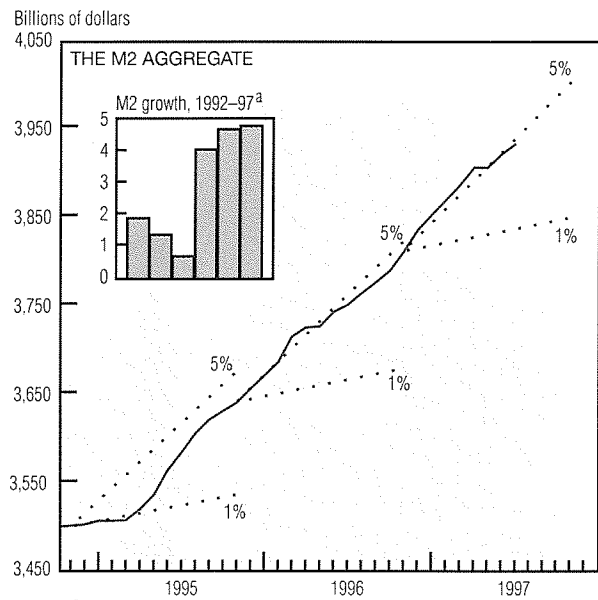
MONETARY AGGREGATES

M1 = Currency
 + Traveler's checks
 + Demand deposits
 + Other checkable deposits

M2 = M1
 + Savings deposits
 + Small-denomination time deposits
 + Retail money market mutual funds

M3 = M2
 + Large-denomination time deposits
 + Institutional money market mutual funds
 + Repurchase agreement liabilities
 + Eurodollars

Debt = Outstanding credit-market debt of the domestic nonfinancial sectors



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on an estimated July over 1996:IVQ basis.

b. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on a preliminary May over 1996:IVQ basis.

NOTE: All data are seasonally adjusted. For M2 and M3, the last plot is estimated for July 1997. For domestic nonfinancial-sector debt, the last plot is preliminary for May 1997. Dotted lines are FOMC-determined provisional ranges.

SOURCE: Board of Governors of the Federal Reserve System.

of policy when market interest rates are falling and the intended federal funds rate is held constant.

At the same time that short-term rates have declined, the implied yield on federal funds futures has flattened out, indicating that earlier expectations of an increase in the federal funds rate have greatly diminished.

The Federal Reserve Board's report to Congress also provides provisional ranges for the monetary aggregates for 1997 and 1998. At its meeting in early July, the FOMC

reaffirmed the 1997 growth ranges for the monetary aggregates and domestic nonfinancial debt that it had set in February. These ranges are 1%–5% for M2, 2%–6% for M3, and 3%–7% for debt. Provisional ranges for 1998 were set at the same levels.

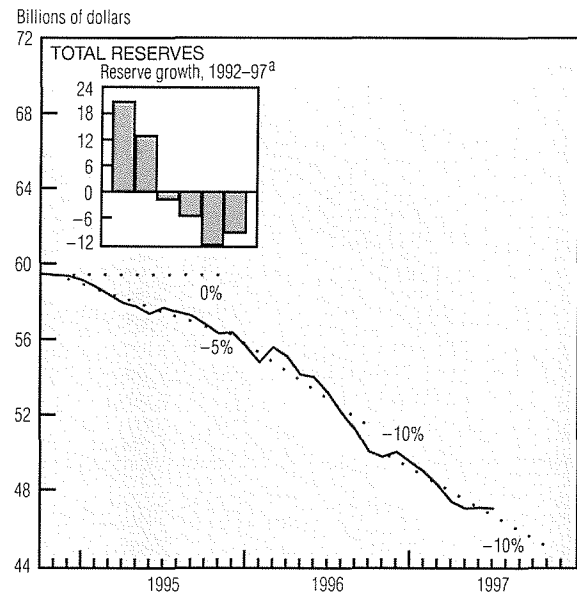
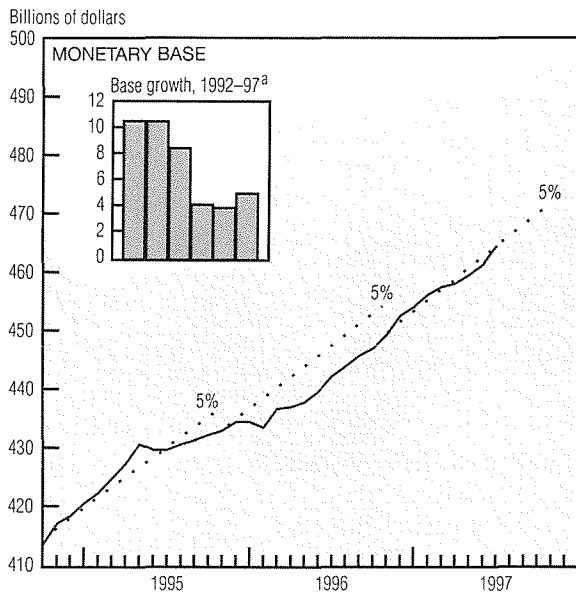
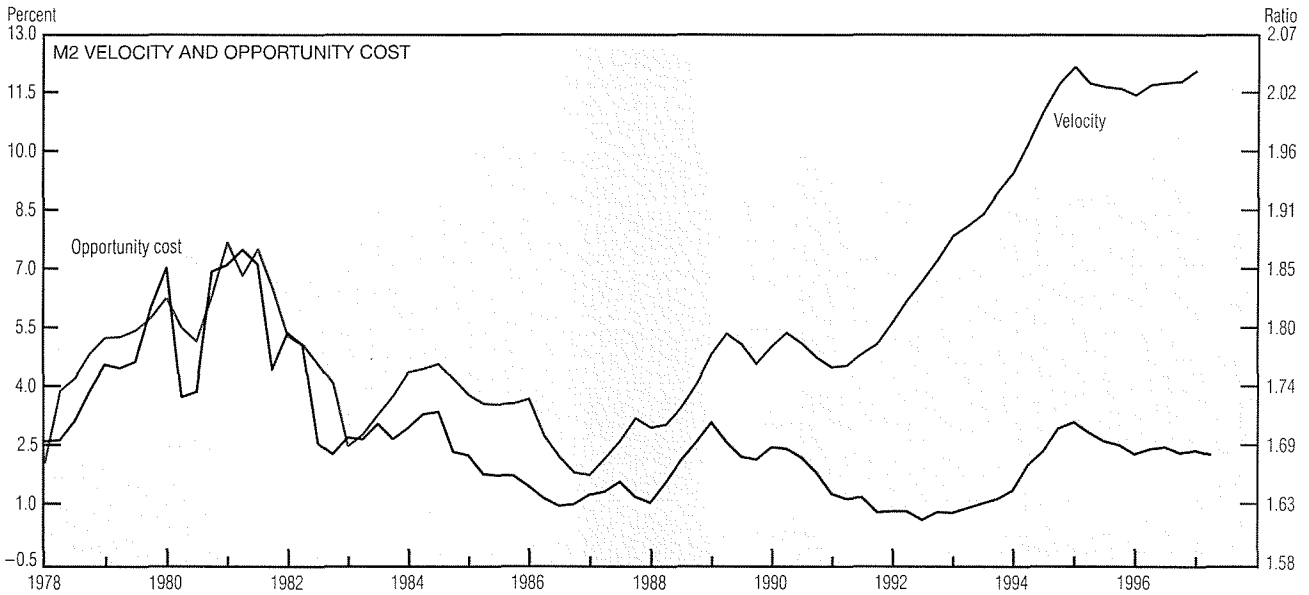
From 1996:IVQ through June 1997, M2 grew at a 4.9% annual rate, just below the upper bound of its range, while M3 expanded at an annual rate of 7.1%, well above its upper bound. Through May, domestic nonfinancial debt increased at a 4.8% annual rate over its

1996:IVQ level, near the center of its range.

In evaluating the policy significance of growth in the monetary aggregates, the Board's report noted that "the correspondence between changes in M2 velocity and in opportunity cost during recent years may represent a return to the roughly stable relationship observed for several decades until 1990—albeit at a higher level of velocity." However, Chairman Greenspan testified that "sufficient evidence has

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Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on an estimated July over 1996:IVQ basis.

NOTE: All data are seasonally adjusted. Last plot is estimated for July 1997. Dotted lines represent growth rates and are for reference only.

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

not yet accumulated” to put more weight on such monetary quantities in conducting policy.

Finally, the Board’s report noted that M1 continued to contract between 1996:IVQ and June 1997, falling at an annual rate of 2.7%. It stated that this decline is probably due to depository institutions’ continuing tendency to “sweep” balances in transaction accounts, which are subject to reserve requirements, into savings accounts, which are

not. The decline in the quantity of deposits held in transaction accounts led total reserves to fall at a 9.8% annual rate. But because of substantial growth in currency holdings, the monetary base (which equals currency plus reserves) increased at an annual rate of 4.5%.

The report sounded a warning about this decline in reserves, stating that “further reductions in required reserves have the potential to diminish the Federal Reserve’s ability to control the federal funds rate closely

on a day-to-day basis.” Moreover, the report argues that “the decline in required reserves over the past several years has not created serious problems in the federal funds market, but funds-rate volatility has risen a little, and the risk of much greater volatility would increase if required reserves were to fall substantially further.” It warns that additional increases in volatility could have negative consequences for the performance of the economy.