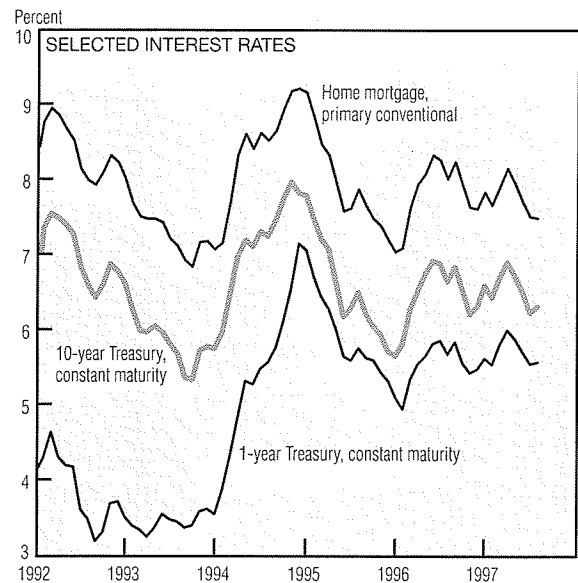
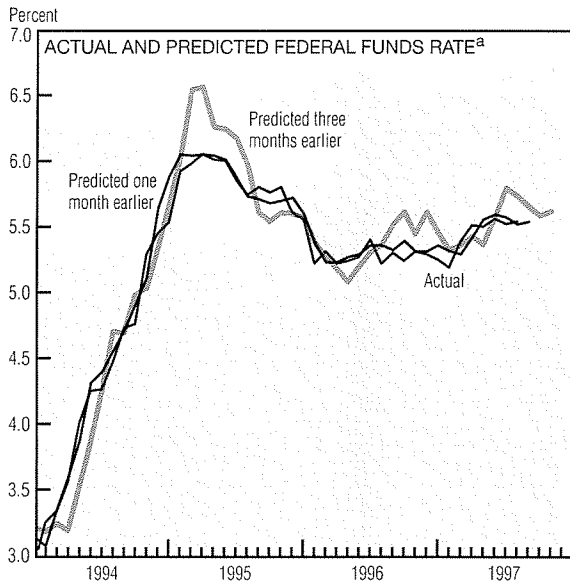
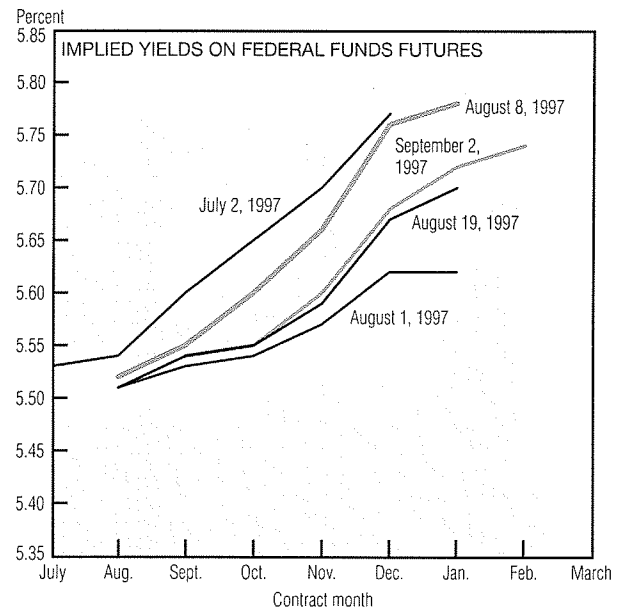
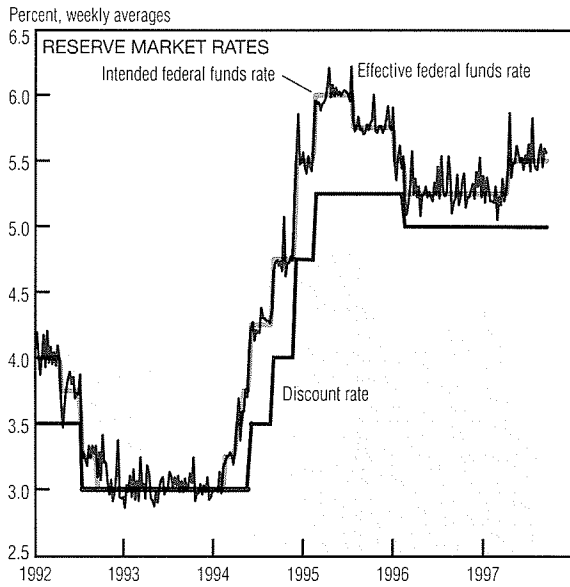


Monetary Policy



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

At its August 19 meeting, the Federal Open Market Committee (FOMC) decided to maintain the existing degree of pressure on the federal funds rate, expecting it to remain around 5.5%. This inaction came as no surprise to the financial markets. The funds rate has been altered only once in the past 19 months—an increase of 25 basis points that occurred at the FOMC's March 25, 1997 meeting. The Committee will reconvene on September 30.

Implied yields on federal funds futures—which provide an unbiased

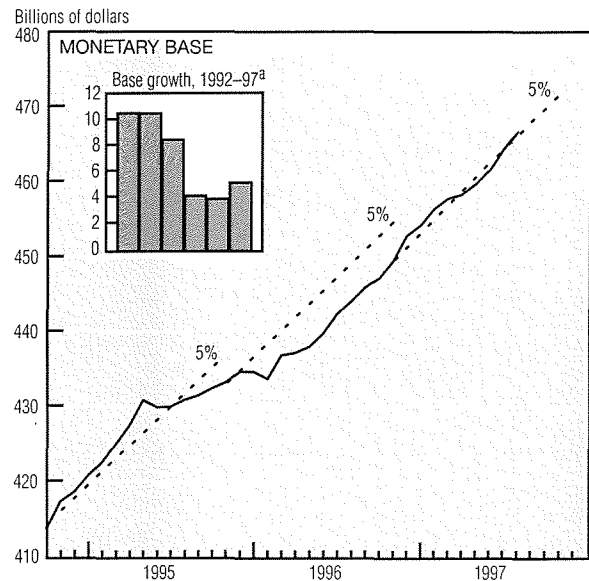
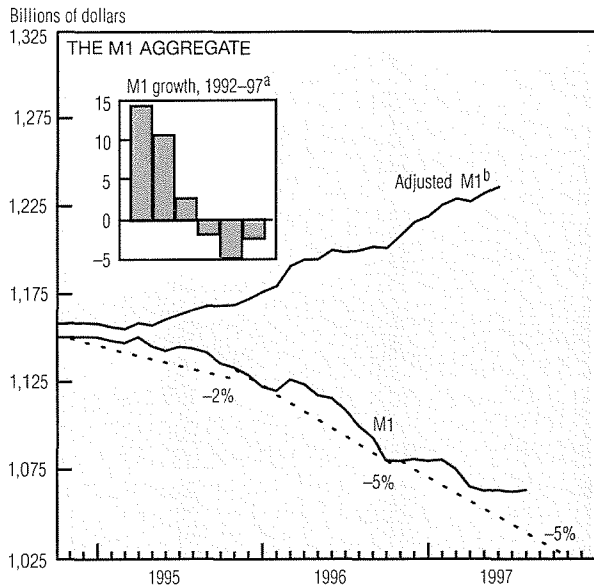
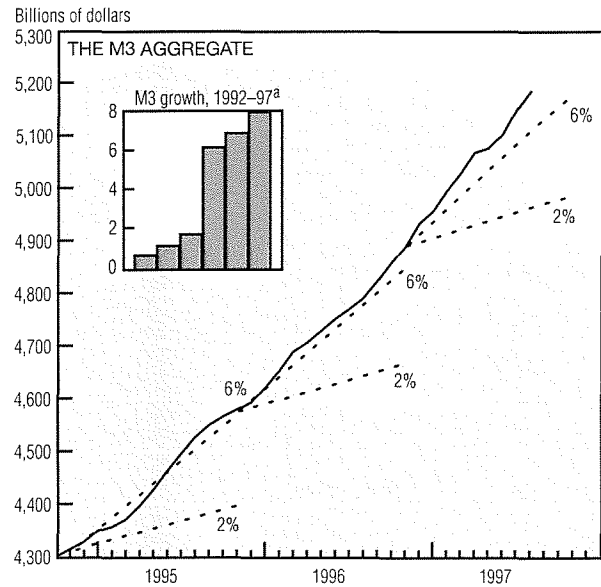
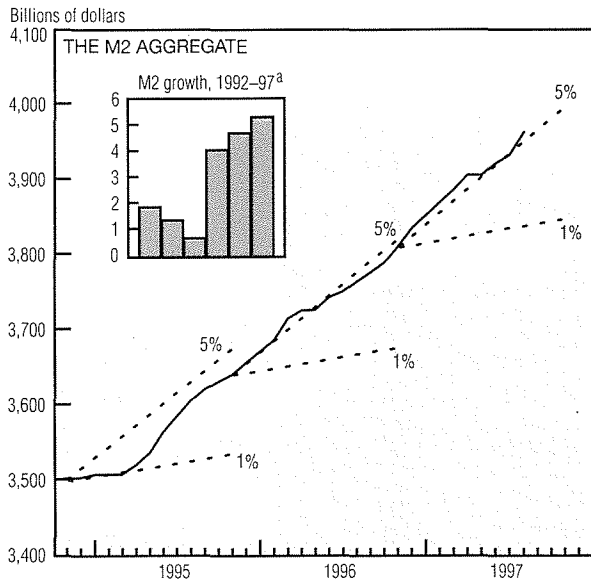
estimate of the market's expectations about the future course of monetary policy—swung widely throughout the month of August. Yields steepened significantly early in the month, perhaps reflecting upward revisions in the growth outlook. Despite continued low inflation, many analysts relate strong output growth to an accelerating price level and believe that the former necessarily prompts the FOMC to raise the funds rate. By the end of August, however, implied yields had begun to flatten, and expectations for a future rate increase were

pushed back to early next year.

Interest rates began rising sharply early in 1997 as market commentary revealed a sentiment for further policy tightening after the March increase. Implied yields on federal funds futures also started to rise. Sentiment reversed during April, and interest rates peaked. Since then, the one-year and 10-year Treasury constant maturities have fallen 43 and 59 basis points, respectively. Home mortgage rates have dropped 66 basis points.

(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 1997 is calculated on an estimated August over 1996:IVQ basis.

b. Adjusted for sweep accounts.

NOTE: All data are seasonally adjusted. Last plot is estimated for August 1997. For M2 and M3, dotted lines are FOMC-determined provisional ranges. For M1 and the monetary base, dotted lines represent growth rates and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

M2 continues to grow at the upper bound of its provisional range, expanding at a 4.8% annual rate through July. Preliminary numbers for the first half of August suggest that the aggregate may exceed the upper bound of its range by the end of the month. M3 has been growing outside its provisional range since the fourth quarter of 1996, and continues to do so. Through July, the aggregate has advanced at a 7.6% annual rate.

Federal Reserve Chairman Alan Greenspan noted in his July

Humphrey-Hawkins testimony that the once-stable relationship between changes in M2 velocity and opportunity cost may have reasserted itself. He warned, however, that there was not enough evidence to justify placing more weight on this measure in monetary policy deliberations.

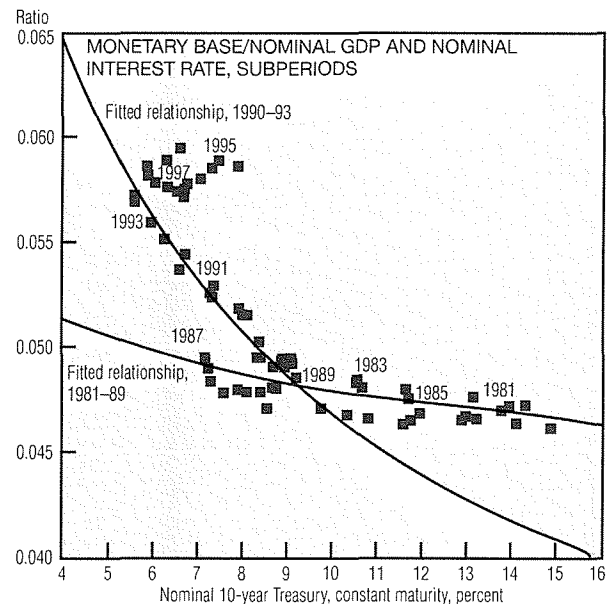
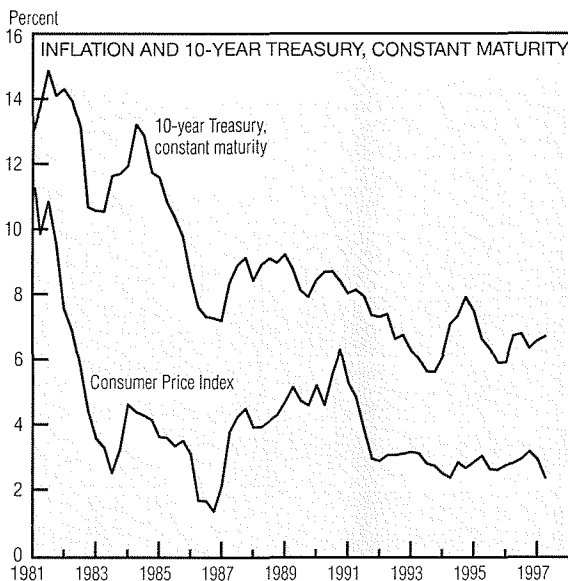
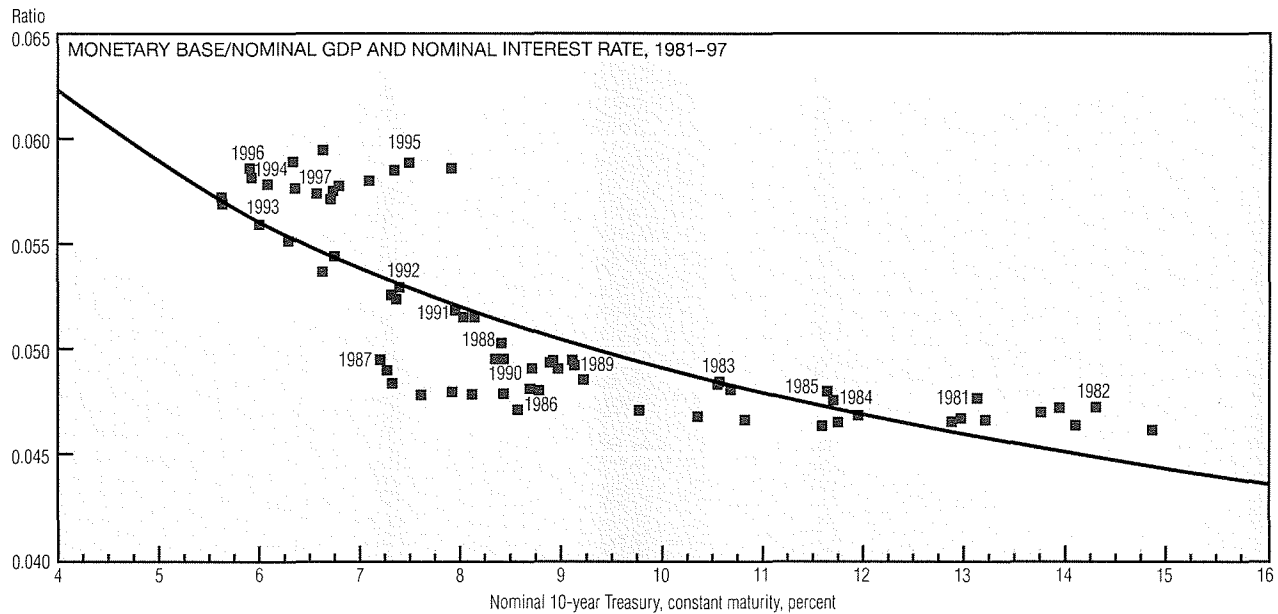
M1 continues to decline, mainly because depository institutions are "sweeping" transaction account balances into money market deposit accounts to economize on their reserves. The decline in the quantity of deposits held in transaction ac-

counts has led M1 to fall at a 2.5% annual rate through July. When adjusted for sweep-account balances, however, the aggregate continues to expand. The monetary base (which equals currency plus reserves) advanced at a 4.8% annual rate through July, reflecting substantial growth in currency holdings.

Money demand is partially determined by interest rates. When plotted against the 10-year Treasury rate, the ratio of the stock of base money (currency plus reserves) to nominal

(continued on next page)

Monetary Policy (cont.)



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

GDP shows a downward curve. Previous estimates of base demand, however, have shown that it tends to be fairly impervious to interest rate changes, contradicting the relative responsiveness suggested by the chart above. A closer look reveals that from 1981 to approximately 1989, base demand was interest-inelastic. As inflation, and hence nominal interest rates, fell from their peak in 1980, base demand as a share of nominal GDP increased only slightly. Yet, from around 1990 to 1993, the demand for currency and reserves grew substantially as interest rates continued to fall.

History suggests that important changes affecting the demand for currency occurred during this period. The collapse of the Soviet Union in 1991 and the fall of the Berlin Wall in 1989 ended 44 years of Cold War hostilities and opened the floodgates for U.S. currency to flow overseas. The demand for U.S. dollars accelerated as the ruble and eastern European currencies eroded in value, causing foreigners to shift to the relatively stable dollar. Concurrent with this increased demand was a decline in U.S. nominal interest rates, making it appear that the

monetary base was more interest-elastic than previously thought.

The higher foreign demand for our currency may have helped suppress the U.S. inflation rate since 1990. For a given increase in the supply of base money, a growing demand for currency implies a lower inflation rate. These potential inflation surprises appear to be over, however. Since about 1994, base demand has been fairly flat, suggesting that the flow of U.S. currency abroad has slowed. Approximately two-thirds of all U.S. currency is now held overseas.