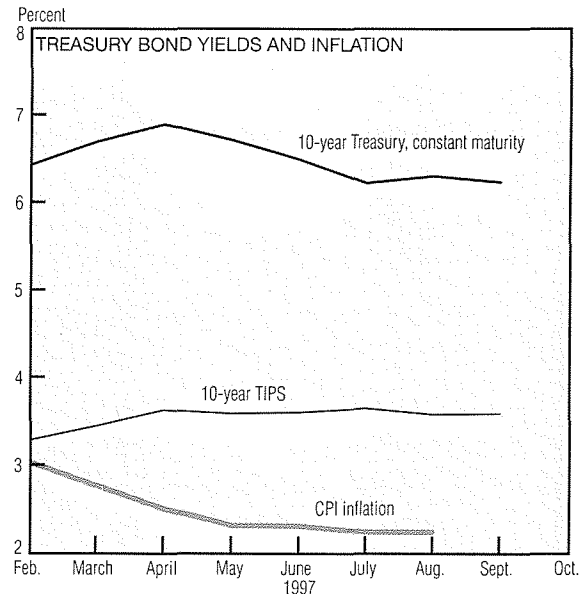
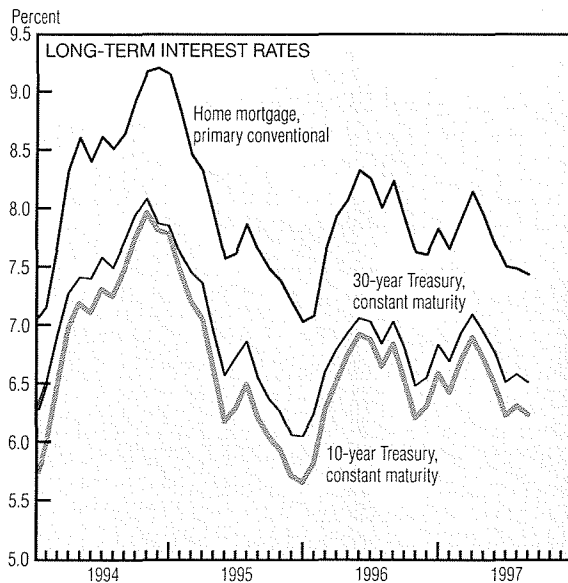
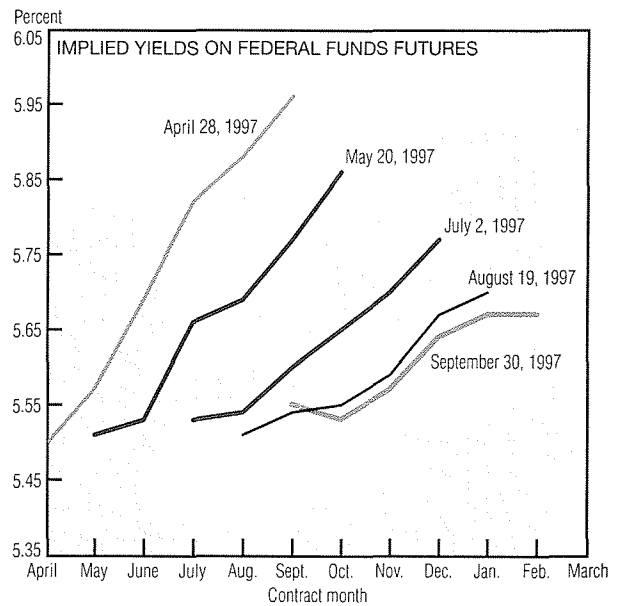
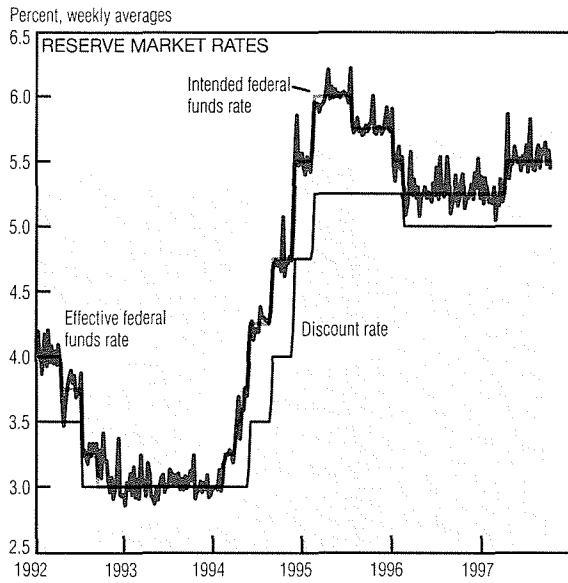


Monetary Policy



SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Labor, Bureau of Labor Statistics; Bloomberg information service; and the Chicago Board of Trade.

The Federal Open Market Committee (FOMC) decided at its September 30 meeting to let the federal funds rate stand at 5.5%, marking six months since the rate was last altered. This inaction came as no surprise to the financial markets, which had widely anticipated the decision. The Committee will reconvene on November 12.

Implied yields on federal funds futures have been flattening throughout the year as expectations for future increases in the funds rate

have been pushed out. Robust economic growth, coupled with continued low inflation and virtually no sign of any future acceleration, has significantly reduced the need for the FOMC to act. The market is not expecting the FOMC to change the funds rate in the near future.

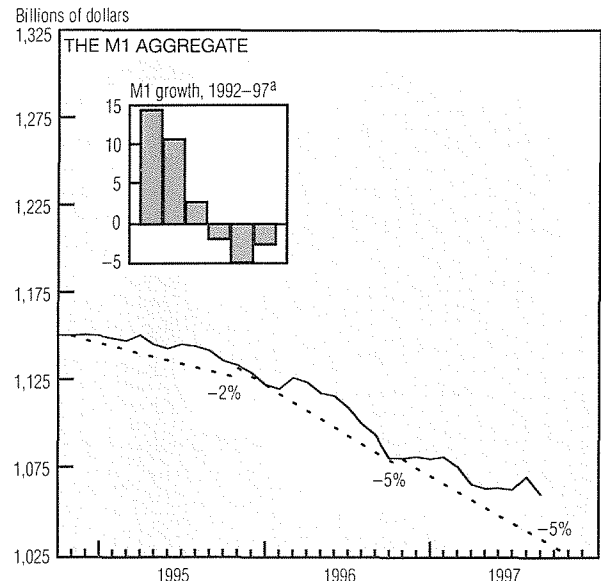
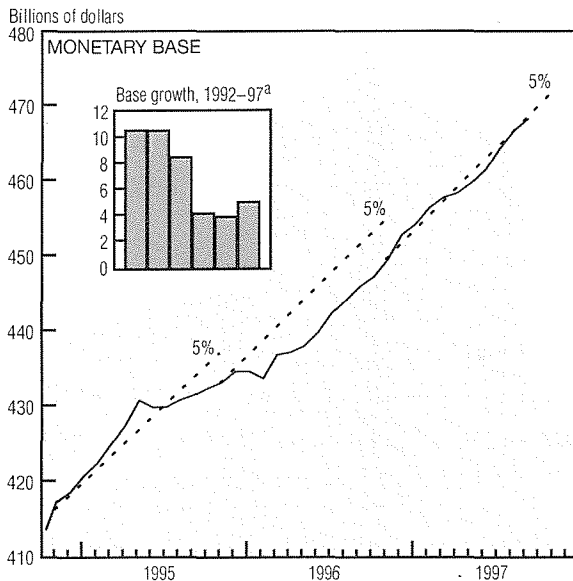
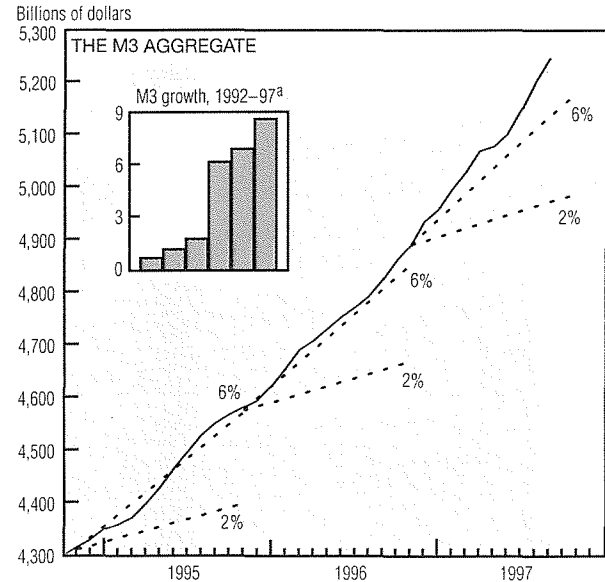
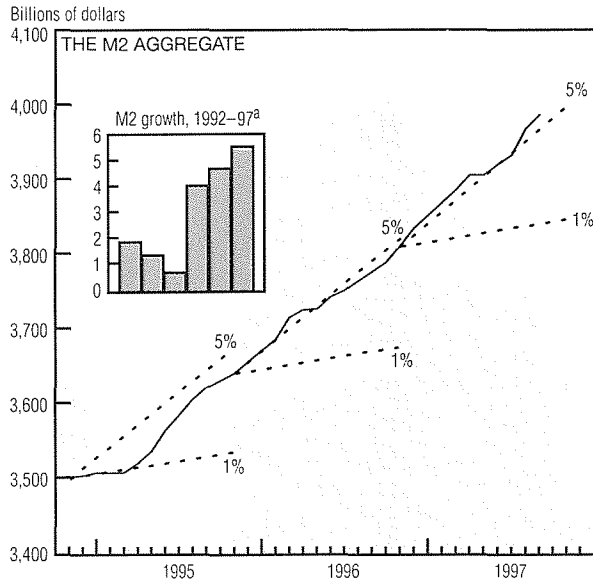
Long-term interest rates fell slightly in September, continuing the downward trend that began in April. The 30-year Treasury constant maturity dropped seven basis points to 6.51%, home mortgage rates fell five

basis points to 7.43%, and the 10-year Treasury moved down seven basis points to 6.23%.

Treasury Inflation-Protection Securities (TIPS) have been trading since late January 1997. Their average yield for the month of September was 3.6%, up 30 basis points from February. In theory, the spread between TIPS and traditional Treasury securities (currently 2.7%) should give some indication of the market's expectations for future inflation.

(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 September over 1996:IVQ basis.

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

SOURCE: Board of Governors of the Federal Reserve System.

However, the market for TIPS is not yet fully developed, and liquidity remains an issue. Investors generally require additional compensation for the extra risk they undertake when markets are less liquid, which affects an investment's yield. Hence, the TIPS/Treasury spread probably embodies more than just an expectation about future inflation, and investors should be cautious when attempting to use it to gauge such expectations.

M2 continues to expand at a rapid

pace, exceeding the upper bound of its FOMC-determined provisional range set last July. Through August, the aggregate grew at a 5.5% annual rate, and preliminary numbers for the first half of September suggest that it will maintain that pace through the end of the month.

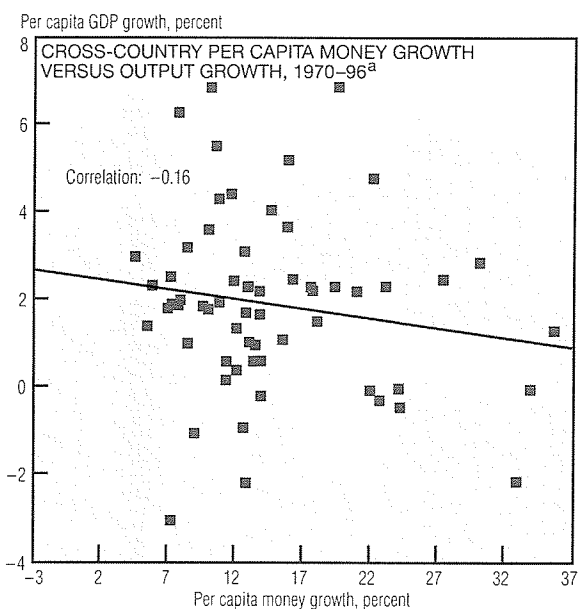
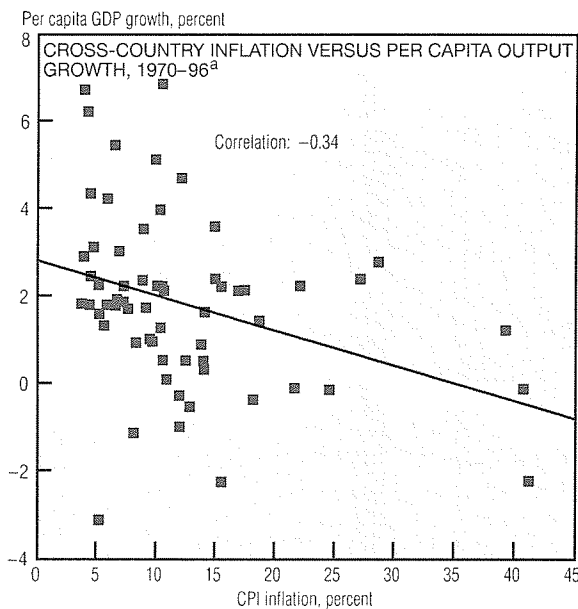
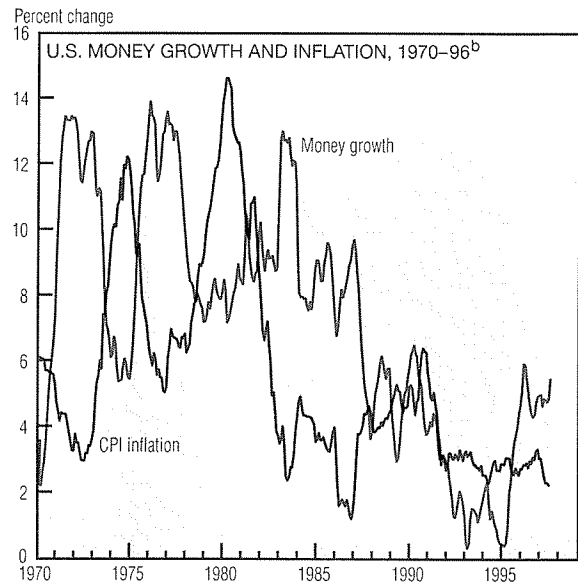
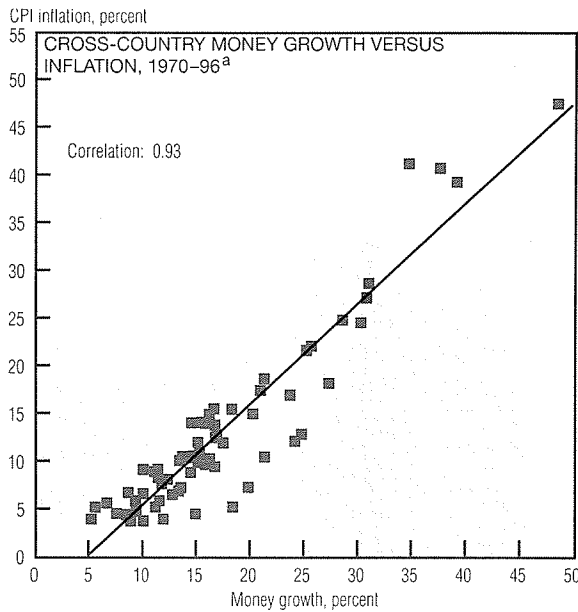
The M3 aggregate accelerated again in August, to an 8.4% annual rate. This is well above its specified range, and also above the growth rate of M2. The surge is attributable in part to robust demand for com-

mercial and industrial loans financed with negotiable CDs, which are included in M3 but not in M2.

The monetary base, a narrower measure of money that includes currency held by the public plus bank reserves, expanded at a 5% rate in August. The primary contributor to base growth in recent years has been its currency component. Foreigners, rather than U.S. residents, are responsible for most of the growth in currency.

(continued on next page)

Monetary Policy (cont.)



a. Average annual percent change.

b. 12-month percent change. Last plot is for August 1997.

NOTE: The sample includes 63 countries.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and International Monetary Fund, *International Financial Statistics*.

M1, another narrow measure of money, fell 1.4% in August, reflecting the continued proliferation of sweep accounts, which allow banks to “sweep” money from reservable to nonreservable accounts in order to economize on their reserves.

Why do economists look closely at money growth figures? Over long periods, there is a strong positive relationship between money growth and inflation. This connection can be clearly seen in the charts above,

which compare average growth and inflation rates across 63 countries over the last two and a half decades. Note that countries with high rates of money growth have almost equally high inflation rates. In the U.S., the relationship is less precise, but still clear: Rapid money growth preceded periods of accelerating inflation in the 1970s, and slower money growth has accompanied our more recent moderate inflation rates.

The inflation consequences of

rapid money growth might be more palatable if the pace of real output also quickened. This is not the case, however. To the extent that any long-term relationship exists between money and per capita output, it is negative. Countries with higher money growth between 1970 and 1996 tended to experience lower output growth. A similarly weak, but negative, correlation between inflation and per capita output growth reinforces this conclusion.