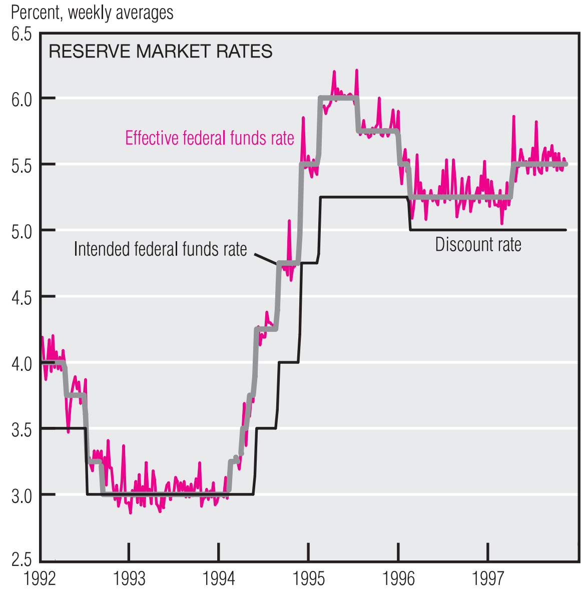
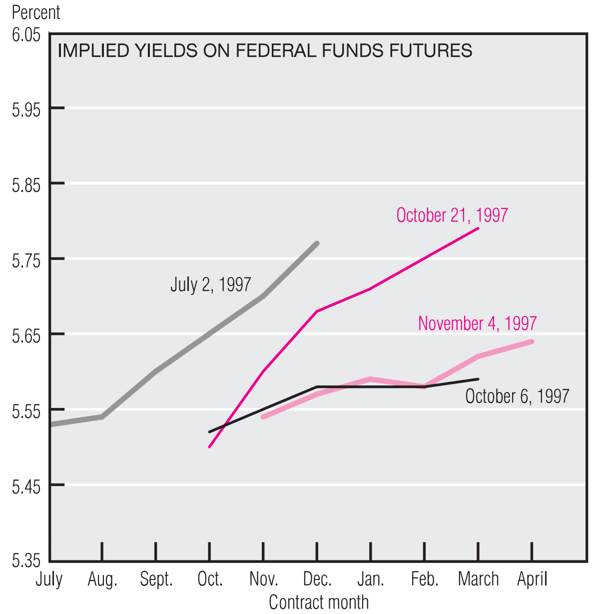
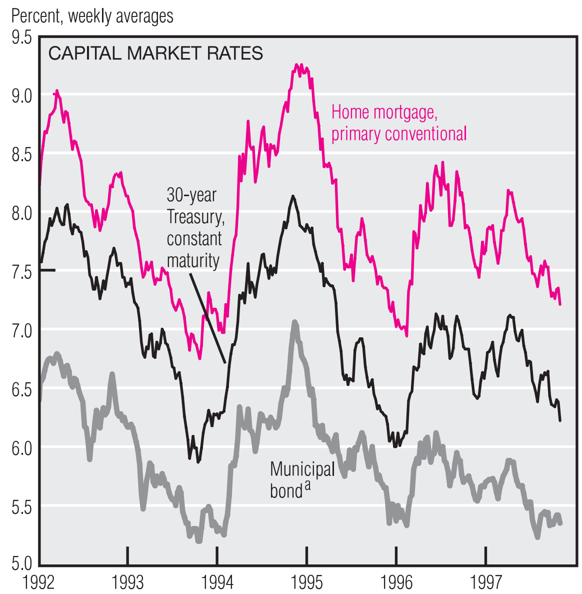
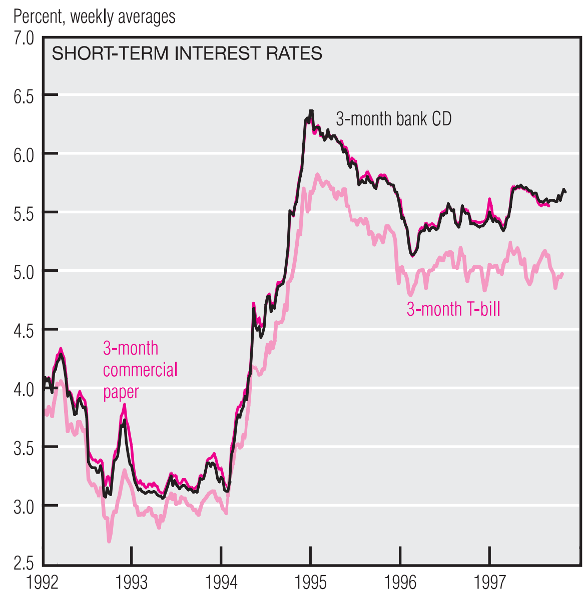
Monetary Policy









a. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

Since February 1996, the Federal Open Market Committee (FOMC) has changed the intended federal funds rate only once, raising it a modest 25 basis points at this year's March meeting. The rate's extended stability largely reflects the combination of low inflation and robust economic growth of the mid-1990s. This outcome is the product of a consistent strategy of maintaining a low-inflation environment, an objective underlying policy decisions since the early 1980s.

Among the chief benefits of persistent low inflation are the decline in long-term inflation expectations and the consequently low long-term interest rates that have characterized the 1990s. Consistent attention and prompt reaction to inflationary pressures have enhanced the FOMC's credibility, a necessary condition for declining inflation expectations. The wide swings in stock prices over recent weeks have been accompanied by lower long-term rates, suggesting investors' continued confidence that the value of fixed-income securities is not threatened by a potential surge in inflation.

Federal funds futures prices reveal many occasions since midyear when market participants expected the FOMC to raise the funds rate before year's end. On October 21, for instance, this market anticipated an increase, possibly coming as early as the November meeting. However, following the sharp drop in stock

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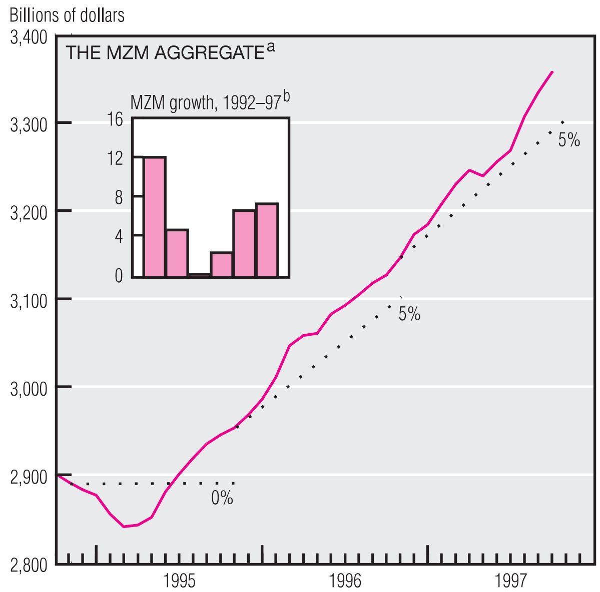
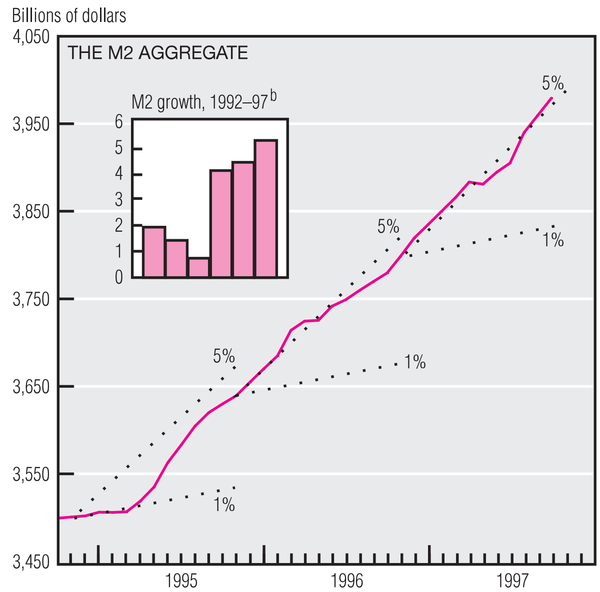
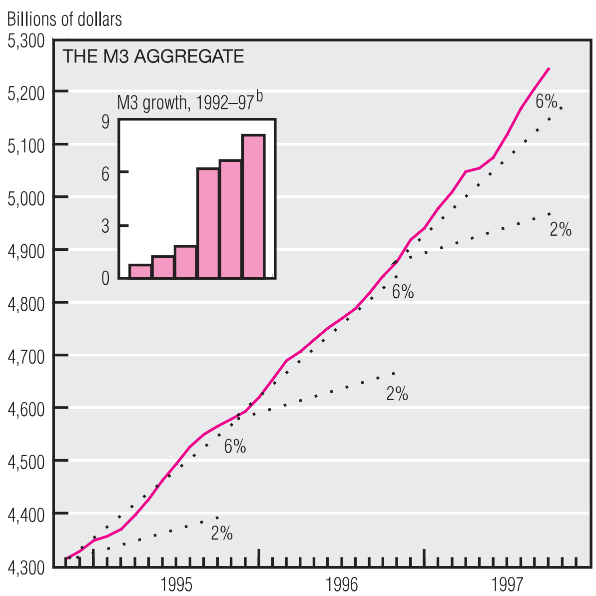
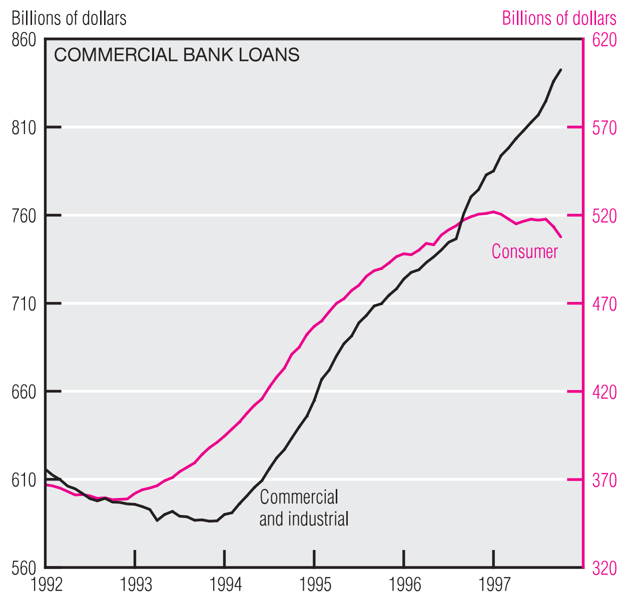
Monetary Policy (cont.)









a. MZM is an alternative measure of money that is equal to M2 plus institutional money market funds less small time deposits.
b. Growth rates are percentage rates calculated on a fourth quarter over fourth quarter basis. Annualized growth rate for 1997 is calculated on an estimated October over 1996:IVQ basis.
NOTE: All data are seasonally adjusted. Last plot is estimated for October 1997. For M2 and M3, dotted lines are FOMC-determined provisional ranges. For MZM, dotted lines represent growth rates and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

prices, it became clear that participants had pushed out the horizon of a likely increase indefinitely.

When things appear to be working well, there's a natural reluctance to tinker. For several years now, the FOMC has conducted monetary policy within a framework that pays little attention to the growth rate of money. Since the summer of 1993, when Federal Reserve Chairman Alan Greenspan reported that the reliability of M2 as an indicator had been downgraded, economic outcomes have been quite favorable. Over the same period, output growth has accelerated to an average rate of around 3%, while inflation has fallen to around 2.1% thus far in 1997. Moreover, what is commonly called the core rate of inflation—the Consumer Price Index less food and energy—rose 2.2% over the past year, the smallest annual increase since 1966. Such results do not inspire significant changes in the way policy is implemented.

Although the FOMC specifies annual objectives for the monetary aggregates, M2 and M3, they are treated as benchmarks for price stability. For the last three years, these ranges have been 1% to 5% for M2 and 2% to 6% for M3. Market participants thus far have little reason to believe that growth outside these ranges would, in itself, motivate the

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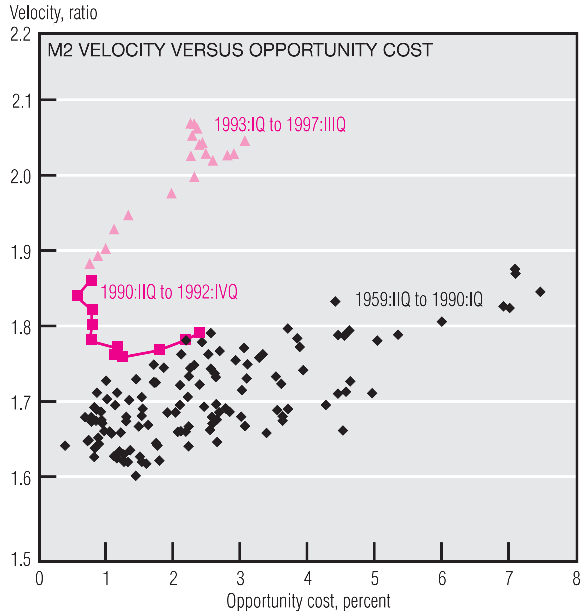

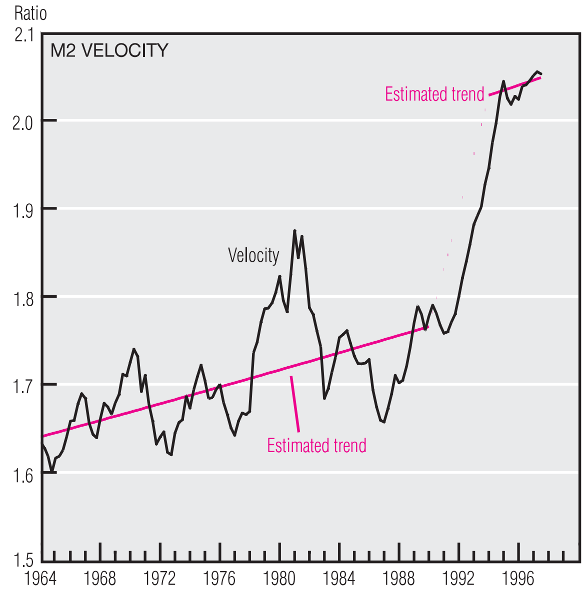

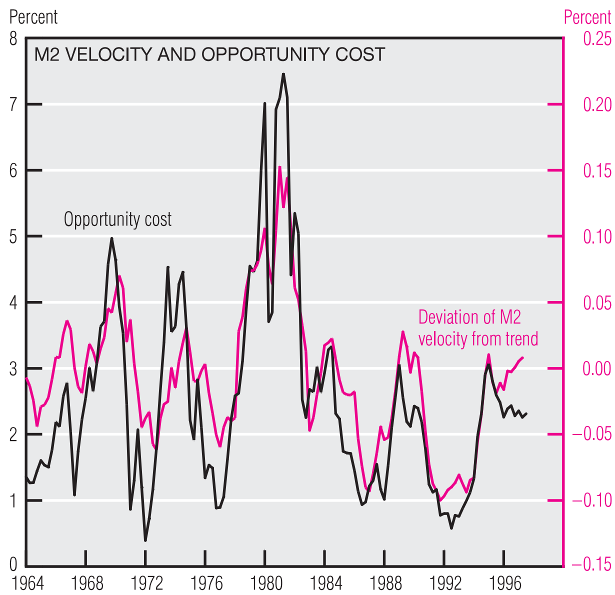

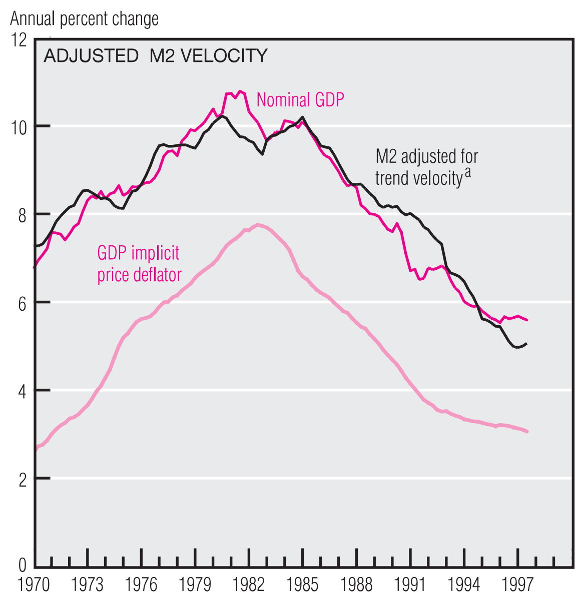

a. Calculated as the rate of growth of M2 less the trend growth in velocity.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and the Federal Reserve Bank of Cleveland.

FOMC to change the intended fed funds rate. Indeed, M2 and M3 have exceeded the upper limits of their specified growth ranges over much of the past two years, with only one increase (in March 1997) in the funds rate.

However, resurgence of growth in the monetary aggregates, particularly M2, has raised concern that inflation could accelerate. Evidence continues to accumulate that M2 velocity—the ratio of nominal GDP to M2—has stabilized into a pattern that is more consistent with historical experience. Thus, M2 growth may now yield more reliable information about underlying economic developments than in recent years.

Historically, M2 velocity has varied directly with M2 opportunity cost—the difference between the Treasury bill yield and the cost of holding M2. The role of M2 slowly diminished in the early 1990s as evidence accumulated that its velocity was increasing much faster than past experience would suggest. After shifting upward for several years, M2 velocity resumed a rate of increase that is more consistent with its historical relationship to opportunity cost.

When M2 growth is adjusted to account for changes in trend velocity, the resulting measure exhibits a stable, consistent long-term relationship to nominal GDP and inflation over the past inflation cycle. If evidence continues to accumulate that M2 velocity has indeed stabilized, an acceleration in M2 growth cannot be sustained without the risk of increasing trend inflation.