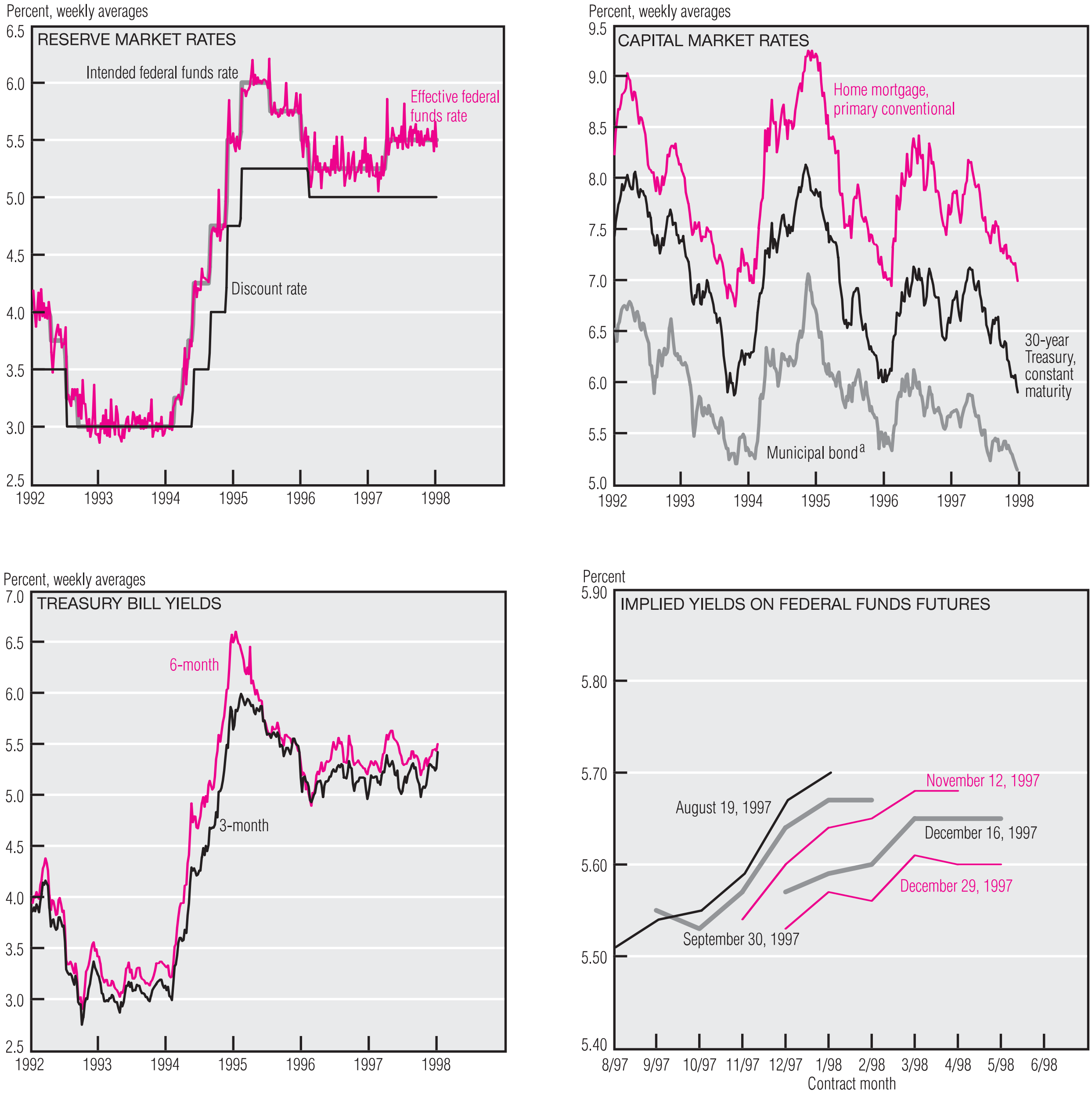
Monetary Policy



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.

At its December 16 meeting, the Federal Open Market Committee (FOMC) left the federal funds rate target unchanged at 5.5%. This decision had been widely anticipated by financial markets in the weeks leading up to the meeting. Most analysts believed that the FOMC would not act in the immediate wake of the Asian financial crisis. The FOMC will reconvene for a two-day meeting beginning February 3.

Long-term interest rates continued to decline in December. The 30-year Treasury yield fell to levels not seen in more than four years. Since the end of November, it has dropped 16 basis points and now stands at 5.9%. Conventional home mortgage rates fell below 7% for the first time in two years. Since the end of November, mortgage rates have decreased 18 basis points and now average 6.99%. Municipal bond yields fell 15 basis points in December and currently stand at 5.14%.

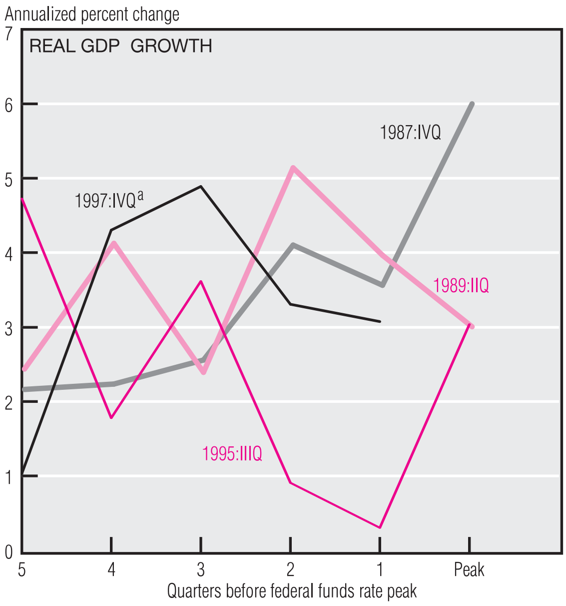
Short-term Treasury yields continued to increase in December. The three-month yield rose 15 basis points to 5.42%, while the six-month yield was up six basis points to 5.5%.

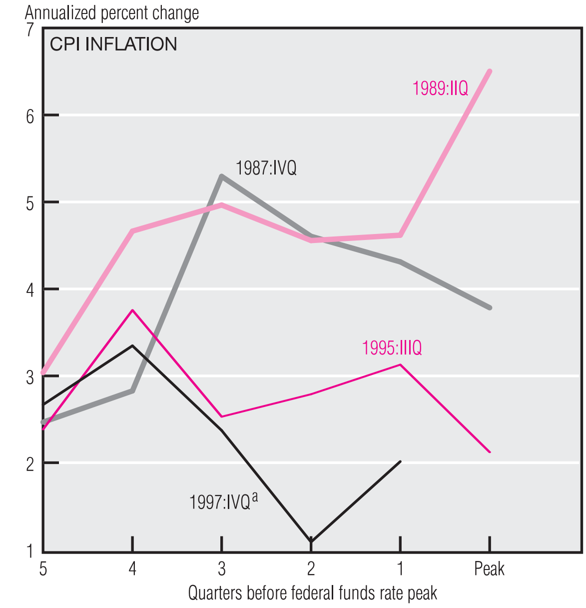
Implied yields on federal funds futures have flattened considerably since August. Federal funds futures allow people to hedge against or speculate on the FOMC's monetary policy stance. The contract is based on the monthly arithmetic average of the daily effective federal funds rate. Because the effective funds rate does not always hit the target, small differences can arise between the settlement price of the contract and the targeted funds rate.

In August, there was an implied yield of 5.7% for the January contract. By the end of December, that yield had fallen to 5.57%. Participants in the fed funds futures market currently see very little chance of the FOMC changing the funds rate

(continued on next page)

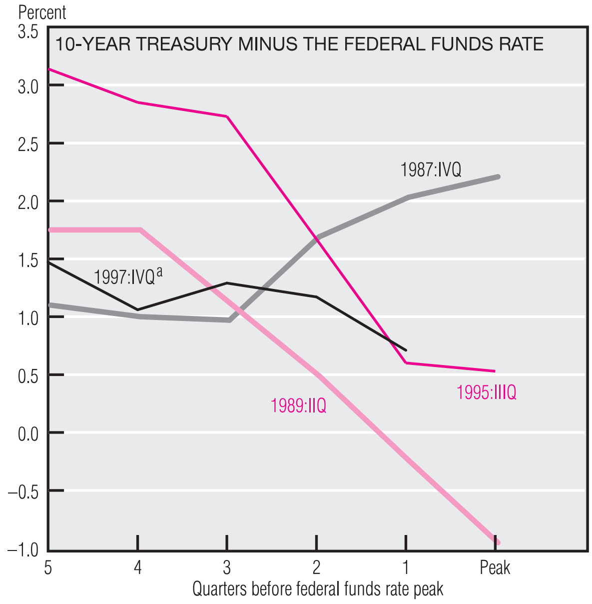
Monetary Policy (cont.)





Federal Funds Rate Tightening Cycles
(Trough to peak)

Trough	Duration (months)	Number of changes	Basis points
1986:IVQ	7	8	150
1988:IQ	14	16	330
1994:IQ	17	7	300
1997:IQ (present cycle)	9	1	25



a. 1998:IQ is treated as a peak for comparative purposes only.

NOTE: Curve labels refer to the quarter in which the federal funds rate peaks. A peak occurs when the federal funds rate falls after a series of increases. All data are seasonally adjusted.

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.

in the foreseeable future. Concerns that the "Asian flu" could be contagious and spread to other developing countries are thought by many to negate the possibility of future rate hikes. A small upward bias remains in the yields, however, indicating that slightly more market participants attach a higher probability to a rate hike than to a cut.

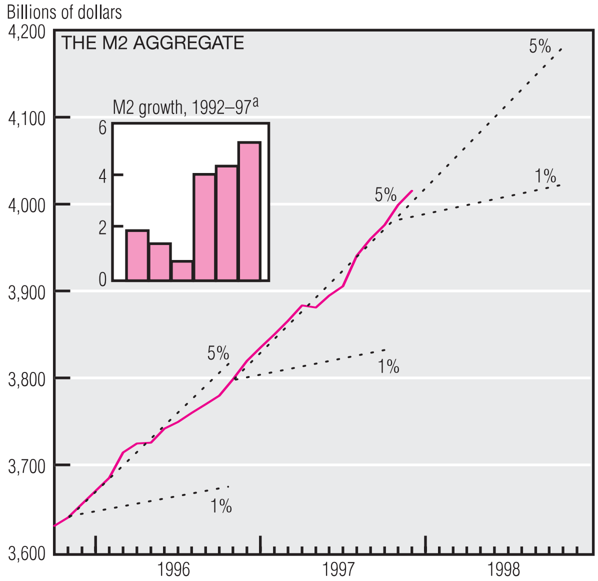
The last change in the federal funds rate, a 25-basis-point increase last March, followed a round of easing that lasted six quarters. Guided by history, market participants at that time had expected the next change in the funds rate to be another rise, since initial rate hikes have always been followed by additional bouts of tightening. This sentiment was reinforced by growing concerns about both strong economic growth and mounting inflationary pressures.

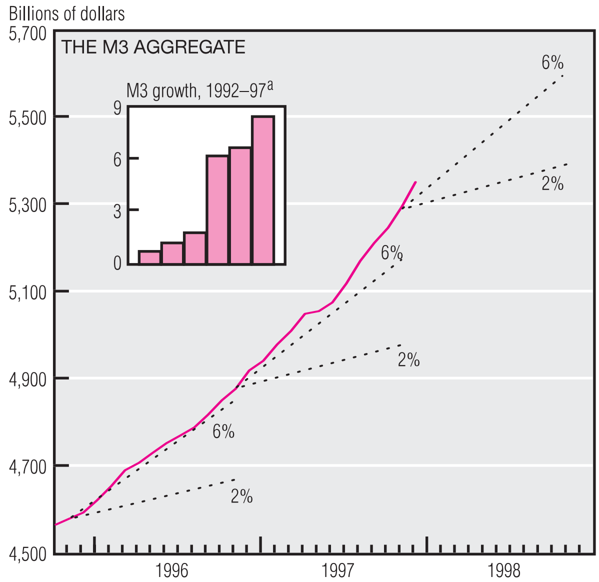
Recently, however, the mood has begun to shift, and some analysts now expect the next rate change to be a cut. According to estimates, the Asian crisis could lower U.S. economic growth by half a percentage point. Many expect this and lower import prices to mitigate inflationary pressures. Usually, inflation eases before rates are cut. If such a policy move did occur, the current 5.5% rate would represent a relative peak in the funds rate—one that is only 25 basis points higher than its previous trough. This would be unprecedented, since a typical round of tightening usually lasts more than a year, with cumulative rate hikes exceeding 300 basis points.

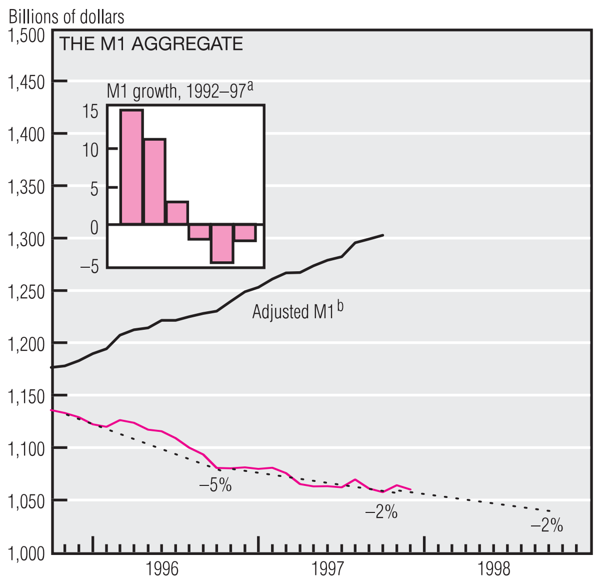
In addition to the Asian situation,

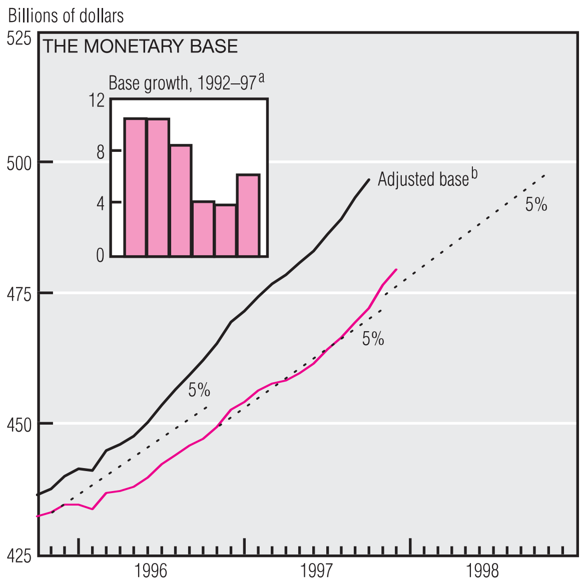
(continued on next page)

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 December over 1996:IVQ basis.

b. Adjusted for sweep accounts.

NOTE: All data are seasonally adjusted. Last plot is estimated for December 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.

the recent change in policy expectations may reflect the flattening of the yield curve. Prior to recessions, long-term Treasury bonds frequently dip below the federal funds rate, a so-called inversion of the yield curve. Currently, this spread is similar to its level preceding the funds rate decrease in July 1995. Caution, however, should be exercised in interpreting movements in the yield curve—especially in comparing levels across time. Flat yield curves need not indicate a slowing economy, but may reflect an increased belief that the Fed will keep inflation low.

The M2 and M3 aggregates continued to accelerate at year's end. M2 grew at a 7% rate in November, and estimates show it expanding about 4.9% in December. The comparable figures for M3 are 11% and 12.8%. From the fourth quarter of 1996 to the fourth quarter of 1997, M2 grew 5.2%, while M3 expanded 8.4%. Both aggregates grew faster than the provisional ranges set by the FOMC in July.

M1 climbed 7.5% in November, but is estimated to have fallen about 4% in December. For the year, it has declined 1.8%. When adjusted for sweep accounts, however, M1 grew about 5.6% through October. The monetary base expanded 11.3% in November, and estimates place its December growth rate at about 7.5%. For the year, the base grew 5.8%. It too is affected by sweep accounts, so that figure is probably understated. Indeed, through October, the sweep-adjusted monetary base was up approximately 7.3% over 1997.