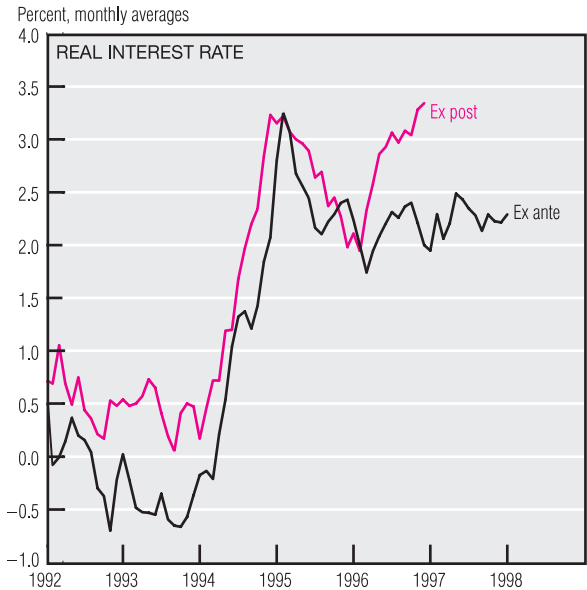
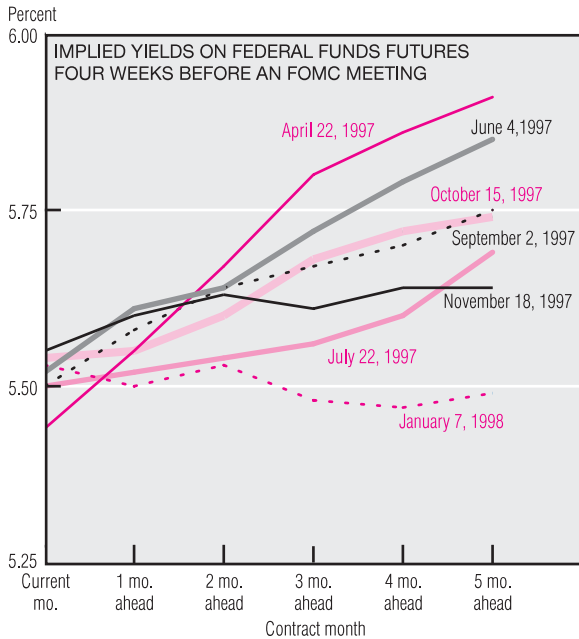
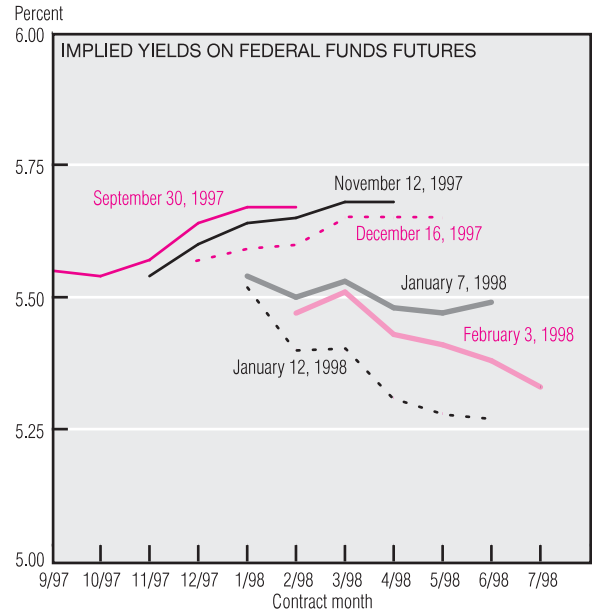
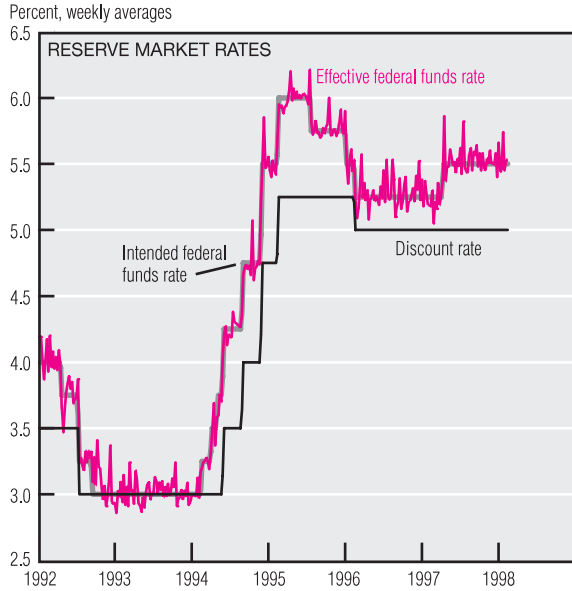


Monetary Policy



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

At its February 3 meeting, the Federal Open Market Committee (FOMC) left the federal funds rate target unchanged at 5.5%, where it has been since March 25, 1997. Financial markets did not expect any change, so the announcement came as no surprise. The FOMC will reconvene on March 31.

A significant development occurred in the federal funds futures market in January, when, for the

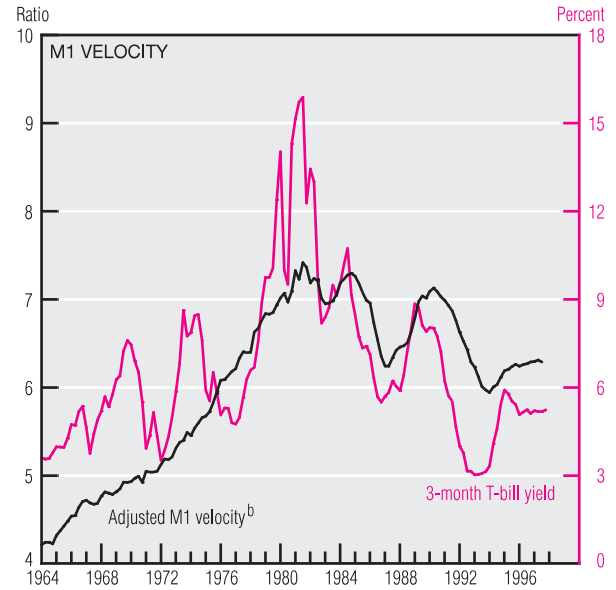
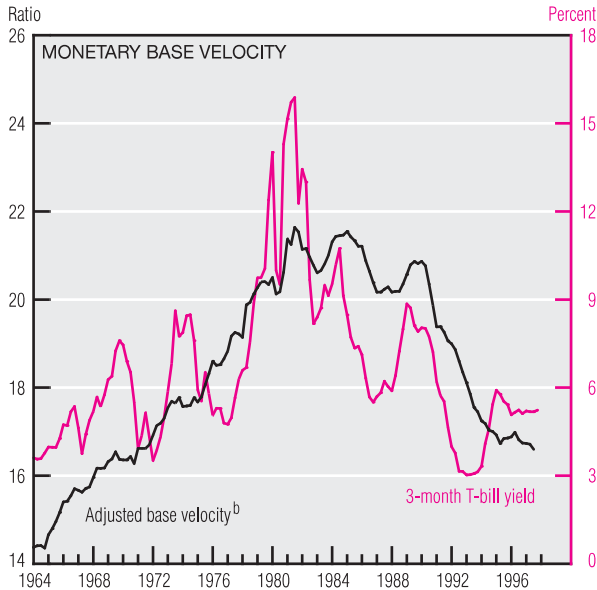
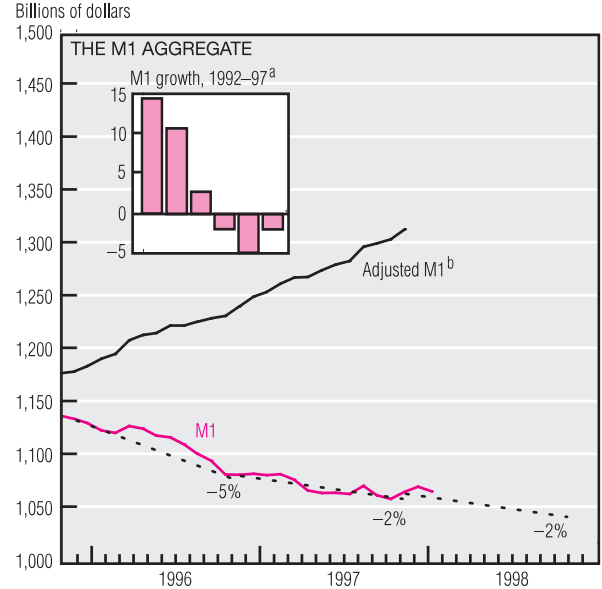
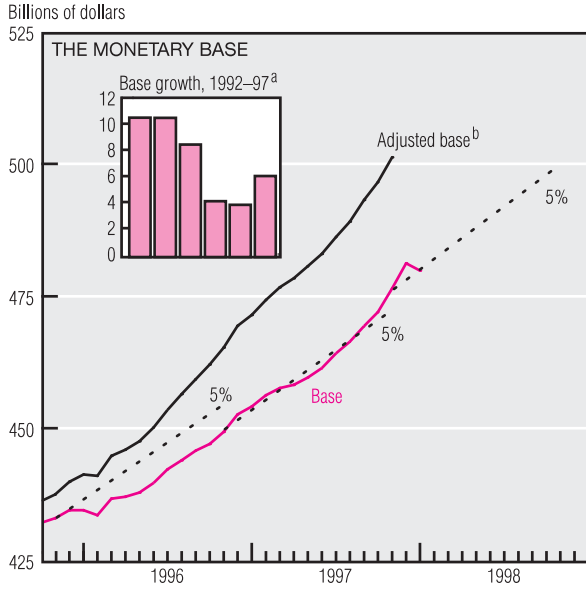
first time since March 1996, implied yields on federal funds futures began to slope downward. Financial markets now attach some probability to a decrease in the federal funds rate, although it is not expected to occur before the end of summer. Many analysts believe that the Asian financial crisis will slow the U.S. growth rate and that cheaper foreign goods will moderate price pressures.

Implied yields on federal funds

futures fluctuated throughout much of 1997. After the 25-basis-point increase in the funds rate last March, implied yields steepened in anticipation of further increases. Expected inflationary pressures did not materialize, however, and implied yields flattened in July. They soon picked up again, and market participants were expecting another increase in September or October.

(continued on next page)

Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.
 b. Adjusted for sweep accounts.
 NOTE: All data are seasonally adjusted. Dotted lines represent growth rates and are for reference only.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

The stock market sell-off in October and Asia's recent financial woes were enough to bias expectations slightly toward loosening.

The real ex post federal funds rate has increased 32 basis points since the beginning of 1996, and is currently at 3.34%. Some analysts interpret this as a de facto tightening of policy, even though the nominal federal funds rate has not changed since March. However, the ex ante real funds rate has been stable over the same period, suggest-

ing that the rise in the real funds rate reflects an unanticipated drop in inflation. The ex ante rate currently stands at about 2.3%.

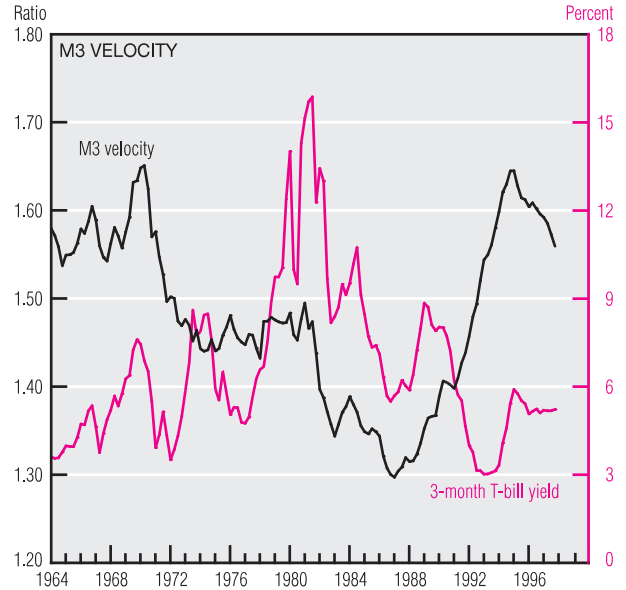
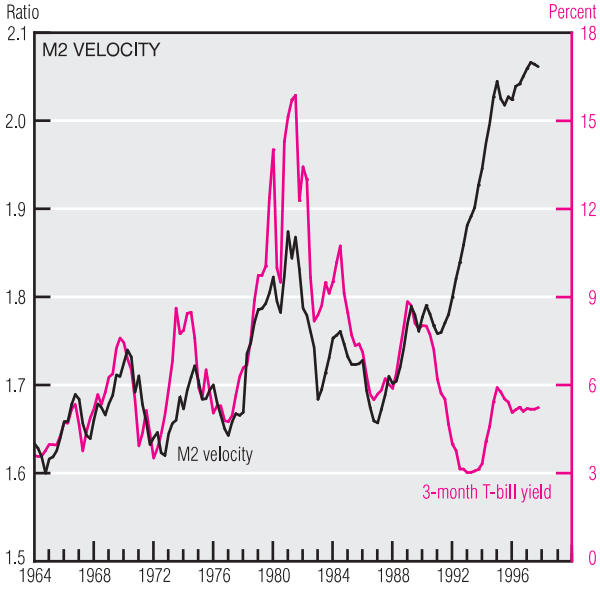
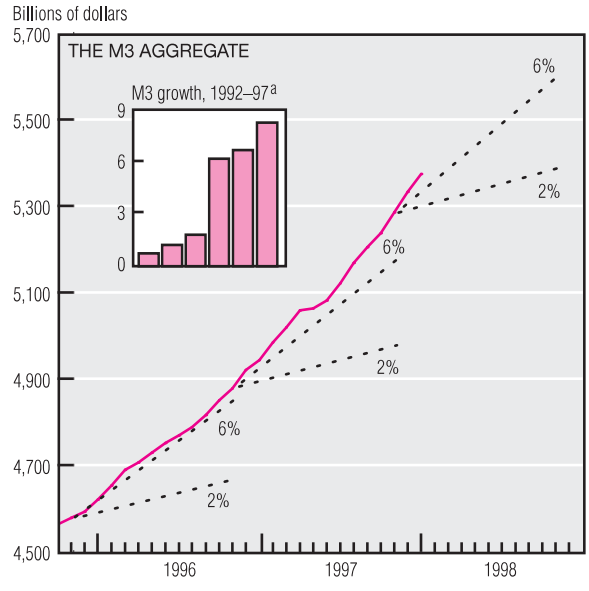
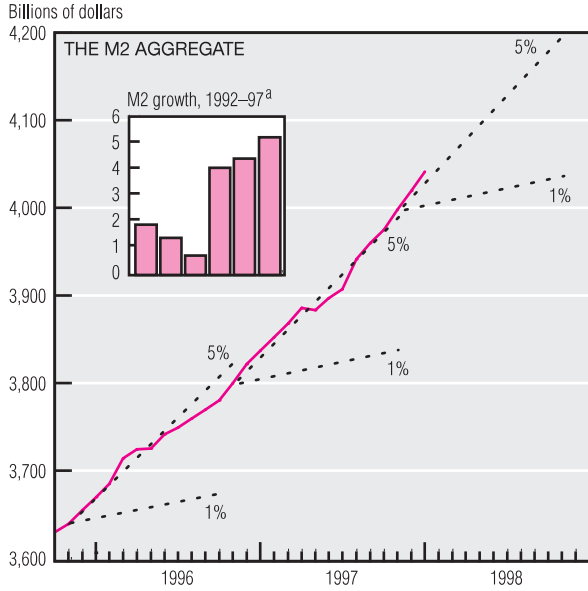
The monetary base, which expanded 6.5% in December, fell about 3.5% in January because its currency component dropped off. On a sweep-adjusted basis, the monetary base grew 11.5% in November. Banks frequently use sweep accounts to economize on reserves, "sweeping" money from accounts that are reservable into

accounts that are not. This distorts the measurement of base growth, as well as M1.

In December, M1 fell 1%, while M2 and M3 grew 5.3% and 8.5%, respectively. On a sweep-adjusted basis, M1 was up 8.8% in November, significantly higher than its non-adjusted rate of 7.5%. Preliminary estimates for January show strong growth in both M2 (6.7%) and M3 (9.4%).

(continued on next page)

Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.
 NOTE: All data are seasonally adjusted. Dotted lines represent FOMC-determined provisional ranges.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

Velocity is measured by nominal income divided by some measure of money. Thus, it can be thought of as the number of times (or the rate at which) a dollar in a monetary aggregate is used in order to produce a unit of final output. Velocity will be affected by interest rates, which impact the opportunity cost of holding money. For example, higher interest rates increase the cost of holding money and so will reduce money demand. As a consequence,

for a given level of nominal income, velocity will rise because people are holding less money. The sweep-adjusted monetary base and M1 velocity roughly follow interest rate movements. Interest rates generally increased until 1980, and have fallen since then. Base growth and M1 velocity show a similar pattern, rising until the early 1980s and then dropping off. After maintaining a similarly positive correlation with interest rates throughout most of its history, M2

velocity rose precipitously in the early 1990s as interest rates fell. The "odd man out" in this picture is M3 velocity, which slowed throughout the 1970s as interest rates trended upward. The velocity of M3 continued to diminish during the 1980s as interest rates generally fell. The run-up in M3 velocity in the 1990s mirrors the pattern of M2 velocity, except that in the past few years, the first has been falling while the second has continued to rise.