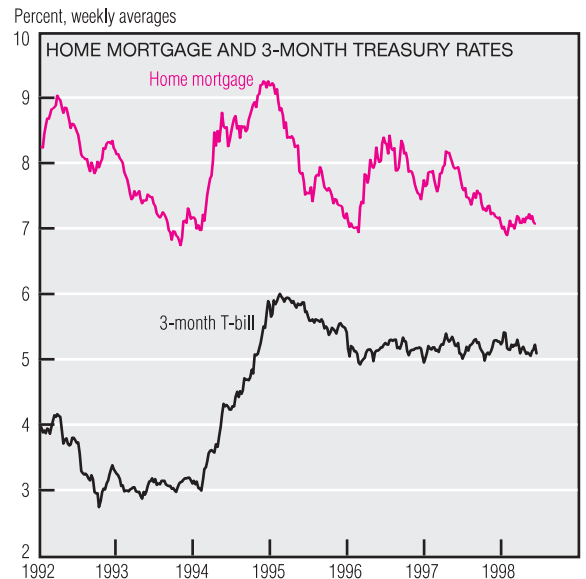
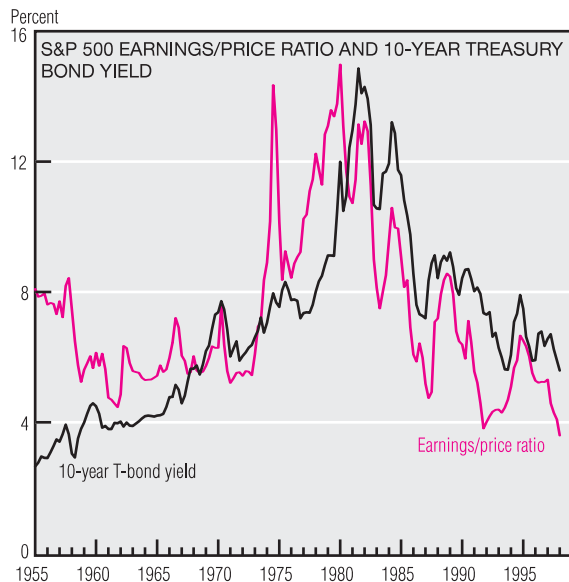
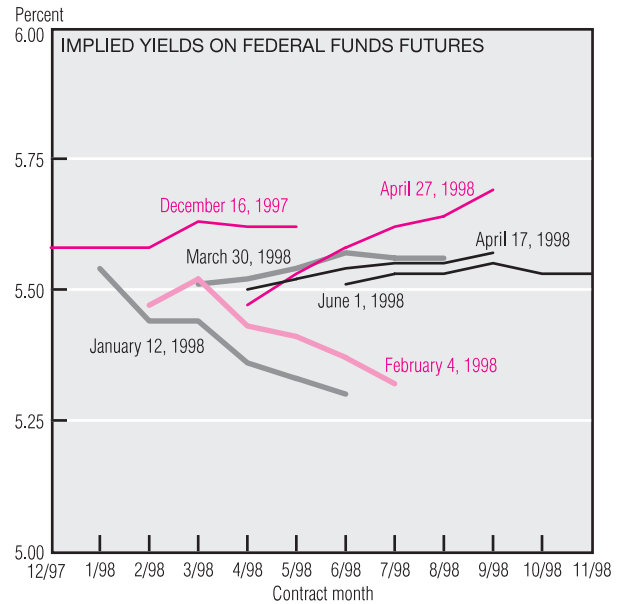
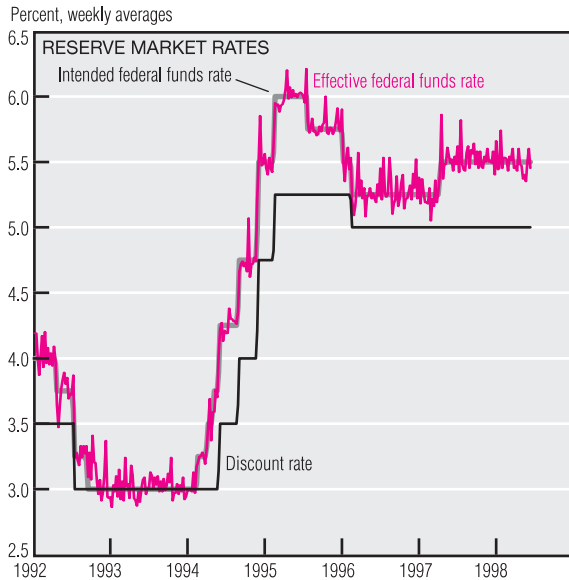


Monetary Policy



SOURCES: Board of Governors of the Federal Reserve System; the Chicago Board of Trade; and DRI/McGraw-Hill.

The Federal Open Market Committee (FOMC) has acted only once in the past 29 months to change its operating target for the federal funds rate. That action—taken in March 1997—increased the intended funds rate just $\frac{1}{4}$ percentage point. By historical standards, the duration of such a passive stance is quite unusual.

To a large extent, the absence of action was made possible by persistent, deliberate efforts since 1979 to achieve progress toward price stability. The credibility gained through these efforts has created an

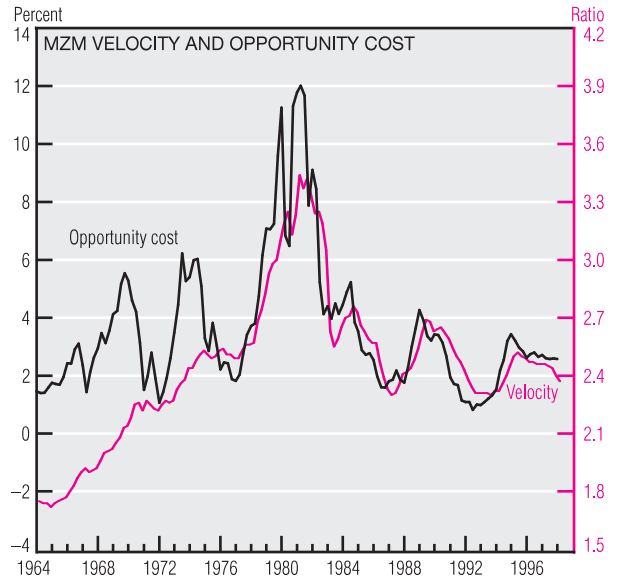
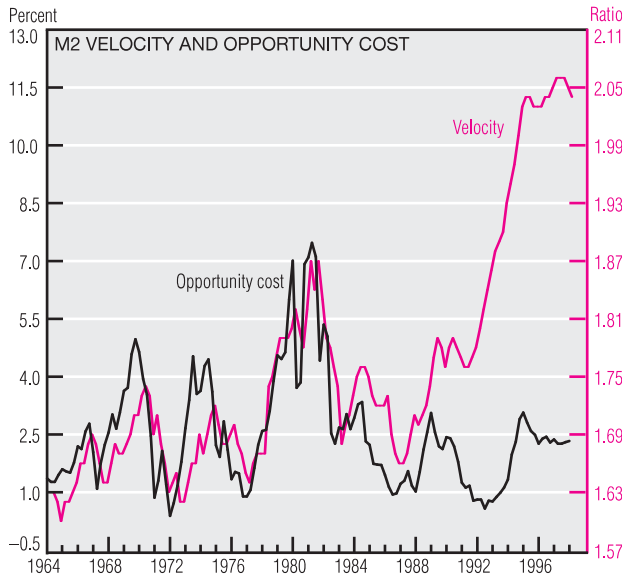
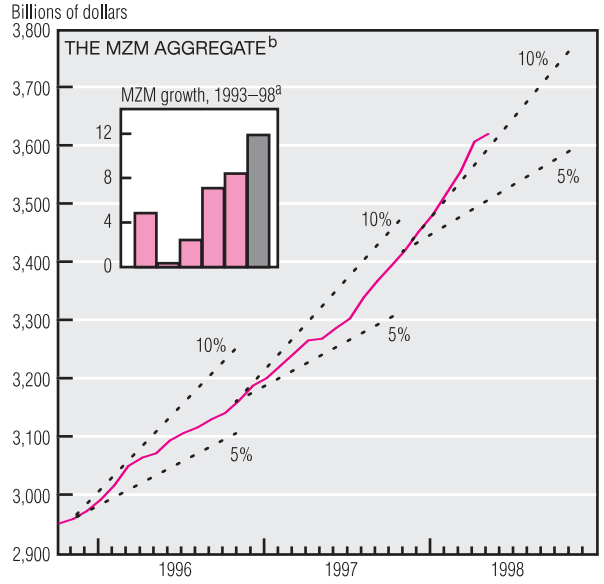
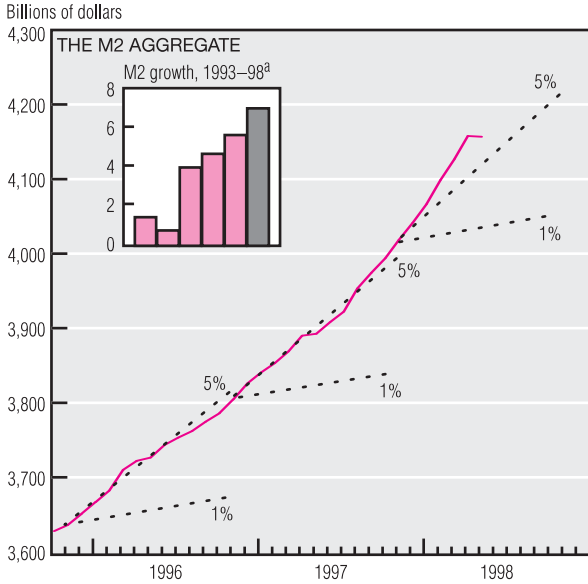
environment in which inflation expectations do not influence private investment decisions. Consequently, market interest rate movements tend to be limited to variations in real economic conditions.

Although opinions on the direction of policy have vacillated in recent months, expectations of further actions have been restrained. The fed funds futures market indicates that participants have not looked for any substantial changes over horizons of five months or so. In recent weeks, futures contracts reveal that no change in the funds rate is expected through November.

The long-term decline in inflation expectations has contributed to favorable capital market conditions. Bond rates are near their 30-year lows. This has been a key factor in the stock market's outstanding performance since 1982. The earnings/price ratio historically follows the 10-year Treasury yield. Falling rates have allowed stock prices to rise even faster than earnings, which have increased at a torrid pace.

Maintaining credibility is essential if the FOMC is to prolong the favorable financial conditions necessary for rapid output growth with low
(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 1998 is calculated on an estimated May over 1997:IVQ basis.
 b. MZM is an alternative measure of money that is equal to M2 plus institutional money market mutual funds less small time deposits.
 NOTE: All data are seasonally adjusted. Last plot is estimated for May 1998. For M2, dotted lines are FOMC-determined provisional ranges. For MZM, dotted lines represent growth ranges and are for reference only.
 SOURCE: Board of Governors of the Federal Reserve System.

inflation. Hard-won gains in credibility could be forfeited if policymakers fail to head off potentially inflationary pressures swiftly. One concern is the upward trend in growth rates for the broad money measures.

M2, for example, has accelerated in each of the past four years. Thus far in 1998, it has increased almost 7%. Much of the run-up can be traced to the extraordinary increases in April tax bills due to unanticipated capital gains, and to refunds that are higher than normal. These

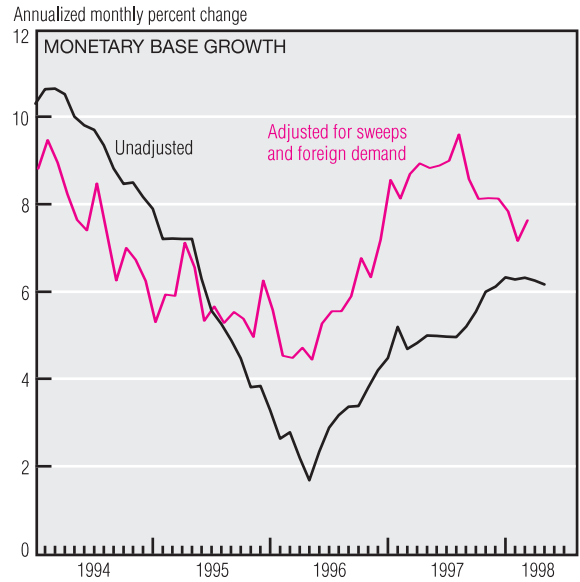
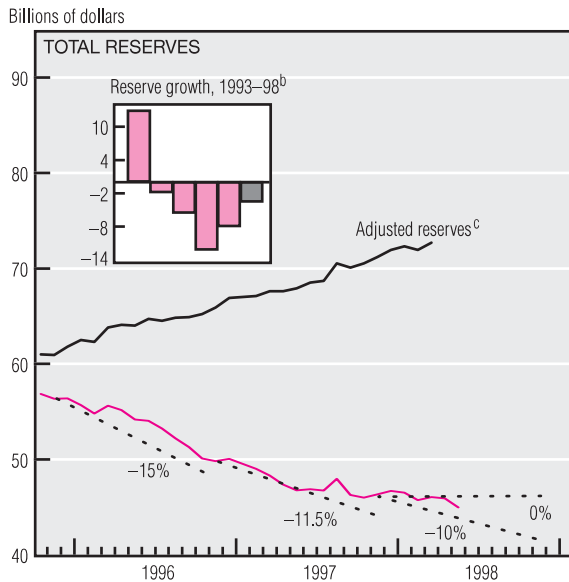
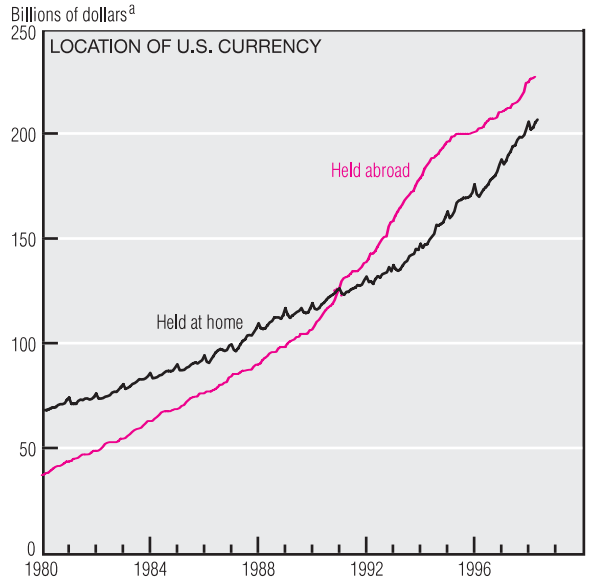
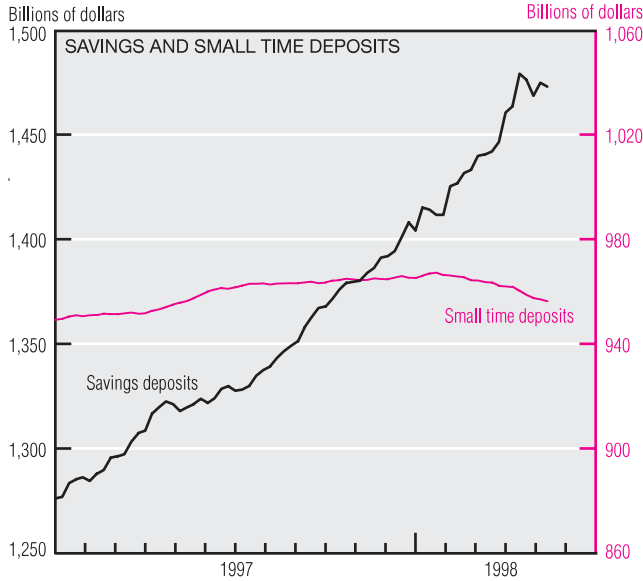
effects have been winding down in late spring.

Although the role of the M2 monetary aggregate in policy deliberations has diminished since 1993, its historical relationship to economic activity has reemerged. Since 1994, M2 velocity—the ratio of nominal GDP to M2—has stabilized around a moderately increasing trend. One implication is that further increases in the M2 trend would ultimately be reflected in an acceleration of nominal GDP, a situation that is not consistent with price stability.

The MZM money measure equals M2 less small time deposits, but includes institutional money market mutual funds. Like M2, its sharp rise in early 1998 largely reflected tax payments. This is most evident in its savings deposit component, which displays a surge and a subsequent offsetting decline around the April 15 tax deadline.

The narrow monetary aggregates, which have been growing more slowly, are difficult to interpret. Their growth rates reflect increases
(continued on next page)

Monetary Policy (cont.)



a. Not seasonally adjusted.
 b. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1998 is calculated on an estimated May over 1997:IVQ basis.
 c. Adjusted for sweep accounts.
 NOTE: All data are seasonally adjusted except where otherwise noted. Last plot is estimated for May 1998. For total reserves, dotted lines represent growth rates and are for reference only.
 SOURCES: Board of Governors of the Federal Reserve System; and the Federal Reserve Bank of St. Louis.

in sweep accounts and foreign demand for currency. Sweep accounts effectively reduce the level of checking accounts relative to spending. For example, even though reserves declined in recent years, the economy accelerated. Adjustment for the effects of sweep accounts reveals that over the past two years, reserves would have grown a robust 6½% in the absence of sweeps.

The U.S. economy's relatively healthy state in the world arena has made the dollar an attractive store of

value in countries whose economies or financial systems are unsettled. For example, currency surged after the Berlin Wall fell. An important positive effect is that foreign willingness to hold U.S. currency—a form of non-interest-bearing debt—reduces Treasury interest payments and hence the burden on U.S. taxpayers.

Foreign holdings, however, are inherently difficult to measure. Since their swings are generally not related to domestic economic condi-

tions, they can obscure the informational value of the monetary base, which is largely composed of currency. Since 1994, annual monetary base growth varied between 2% and 10½%. When adjusted for the effects of foreign currency demand and sweep accounts, the aggregate varies within a narrower range of 4½% to 9½%. Although its growth rate has been trending downward, the adjusted measure is still increasing at a robust pace.