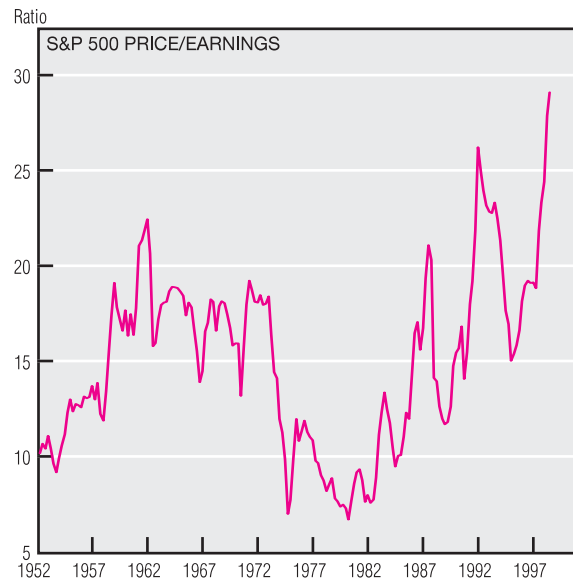
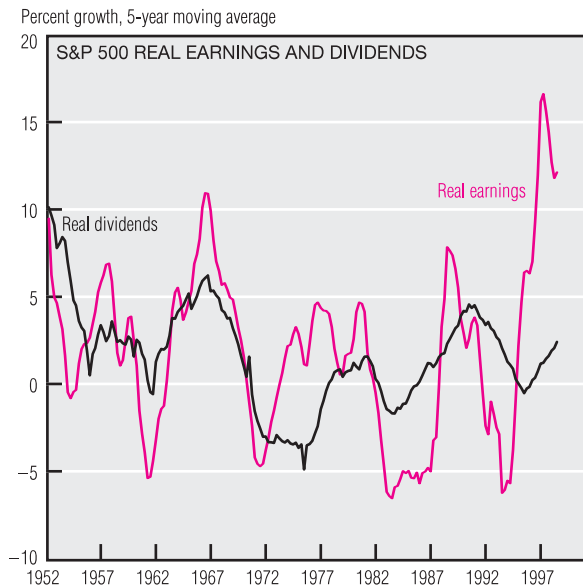
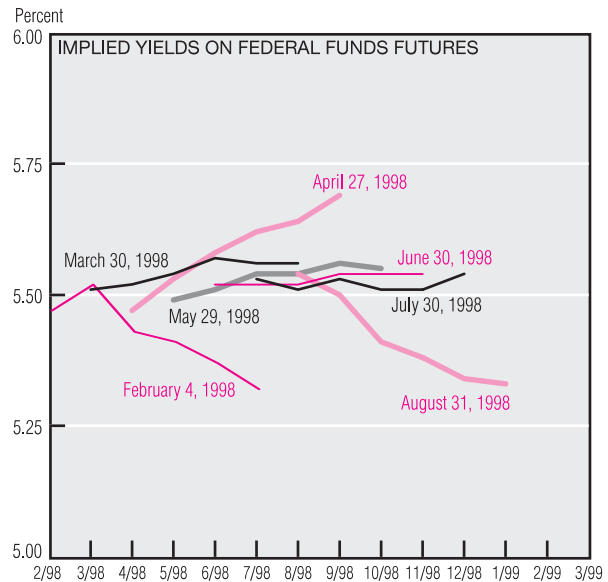
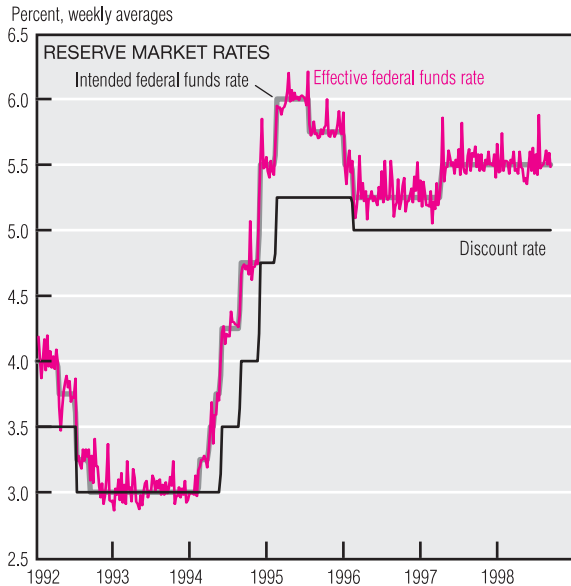


Monetary Policy



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

Over the past several years, the Federal Open Market Committee (FOMC) collectively has seen little basis for taking action. The FOMC last changed the fed funds rate objective in March 1997, increasing it a scant 25 basis points. This increase was preceded by a rate cut of the same magnitude in February 1996. Thus, for almost three years, the FOMC has instructed its Trading Desk to add or drain base money in order to maintain the fed funds rate at or just under 5½%. As recently as the end of August, fed funds futures prices suggested that the outlook for the funds rate was more of the same.

Such a long period of passive policy tactics, rare by historical standards, largely reflects the unusual combination of a long economic expansion and a moderately declining inflation rate. These favorable circumstances are in part the fruit of a deliberate policy strategy that recognizes price stability as essential for a healthy economy.

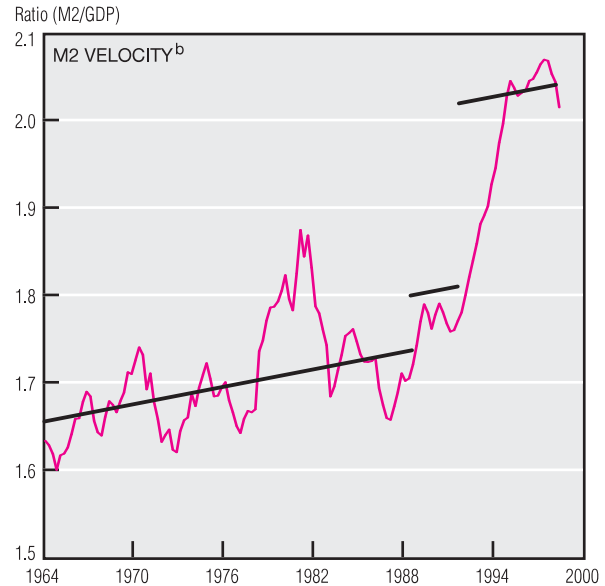
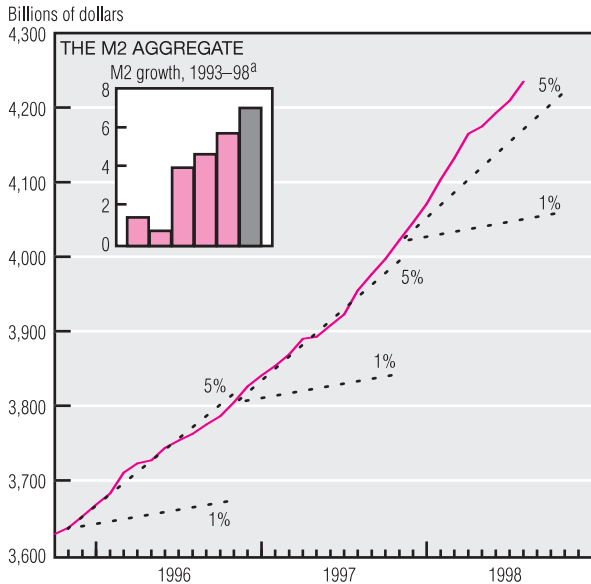
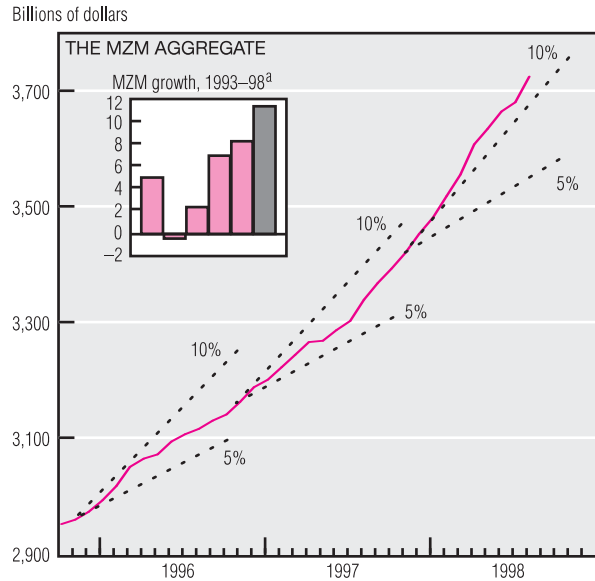
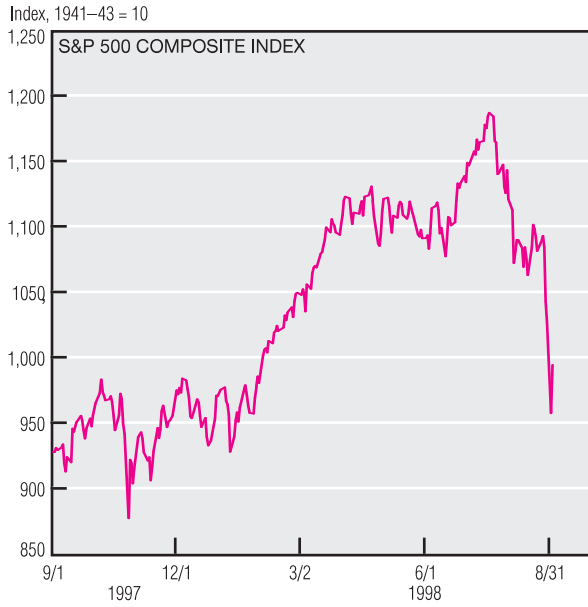
The FOMC's strategy for achieving price stability has yielded an environment in which private investment decisions are made on the basis of economic merit, not as a hedge against inflation. As a consequence, corporate profits have been

extraordinary in recent years. The earnings for Standard and Poors (S&P) 500 companies, for example, have grown at double-digit rates over most of the current expansion. This strong earnings growth provided the fundamental impetus for the stock market's favorable performance in recent years.

While much of the stock market increase was based on improved earnings, a good part was based on expectations of a sustained continuation of extraordinary earnings growth enabled by a robust economy. This optimism was evident in

(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 August over 1997:IVQ basis.
 b. Straight lines represent levels and breaks estimated using the opportunity cost of M2, time, and M2 velocity lagged one quarter as regressors with fixed coefficients.
 NOTE: Data are seasonally adjusted. Last plots for M2 and MZM are estimated for August 1998. For M2, dotted lines are FOMC-determined provisional ranges. For MZM, dotted lines represent growth levels and are for reference only.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Federal Reserve Bank of Cleveland; and DRI/McGraw-Hill.

the price-earnings ratio, which reached historical highs. A belief that the strong domestic economy could continue to be insulated from the turmoil occurring in Asia was reinforced by output growth that showed no signs of slowing through 1998:Q1.

Recent weeks, however, have produced other concerns. Stock markets in Russia and elsewhere in Eastern Europe have fallen precipitously. The markets of Asia continue to slide. The drop of nearly 20% in

the S&P 500 stock index since its peak in July suggests that investors have begun to doubt the continued insularity of the U.S. economy in the face of world financial crises. Stock market corrections of around 20% are rare, but three of them have occurred in the past 11 years. Little is known about the mechanisms that precipitate such large corrections. Moreover, they are not identifiable until after they have occurred.

One potential problem would be an accelerating world financial crisis

that leads to extraordinary demands for liquidity within the U.S. When such circumstances have occurred before (as in 1987), the Fed has stood ready to supply all legitimate needs. At this point, however, liquidity appears to be sufficient. MZM measures domestic asset holdings which have zero maturity and hence are available on short notice. MZM has grown more than 10% in 1998. The broader M2 money measure has increased more than 7% for the year.