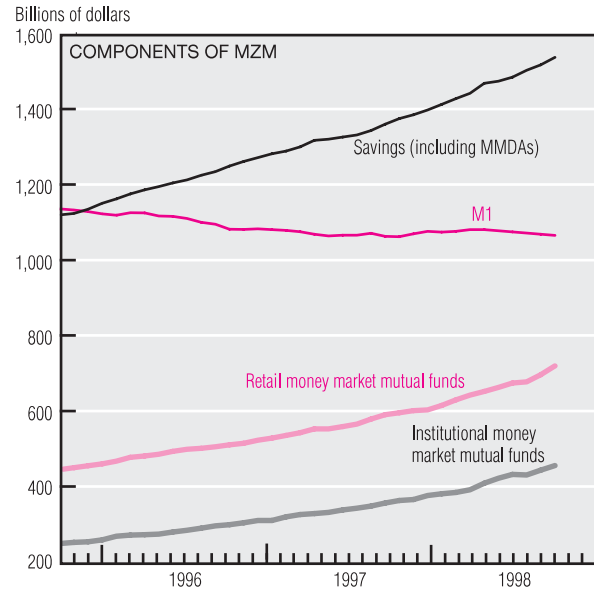
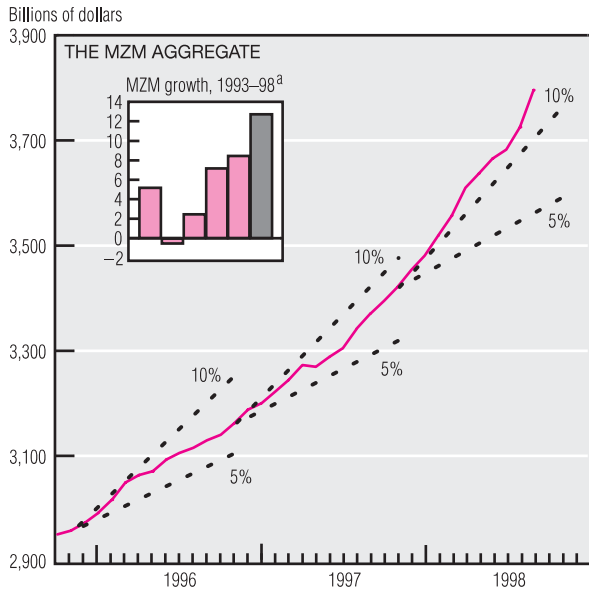
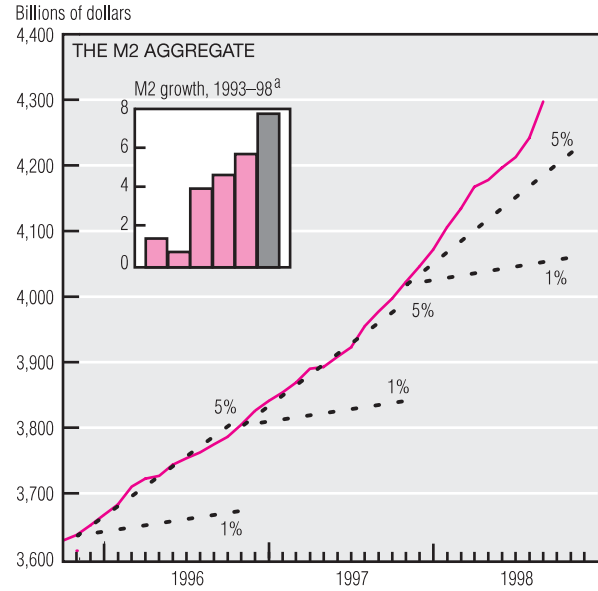
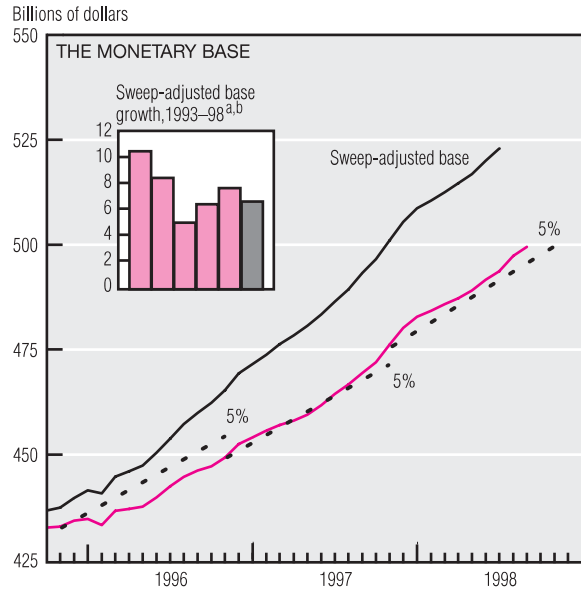


Monetary Policy



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for M2 and MZM in 1998 is calculated on an estimated September over 1997:IVQ basis; for the sweep-adjusted base, 1998 growth is calculated on a July over 1997:IVQ basis.
 b. The sweep-adjusted base includes an estimate of required reserves saved when balances are temporarily shifted from reservable to nonreservable accounts.
 NOTE: Data are seasonally adjusted. Last plots for M2 and MZM are estimated for September 1998. Dotted lines for M2 and the monetary base are FOMC-determined provisional ranges. Dotted lines for MZM represent growth in levels and are for reference only.
 SOURCE: Board of Governors of the Federal Reserve System.

The monetary base continues to grow at a rate slightly higher than its FOMC-determined provisional growth range of 5%. When adjusted for sweep accounts, which move balances automatically into money market deposit accounts (MMDAs) to avoid reserve requirements on transactions deposits, the base has grown at a 6.5% annual rate through July (the most recent month for which sweep-account data are available). No provisional range is set for this measure of the base, but its growth rate is slightly lower than the 7.6%

growth of 1997.

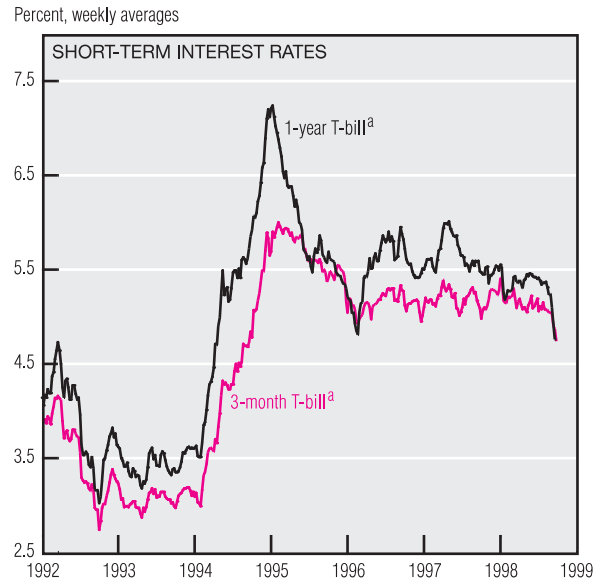
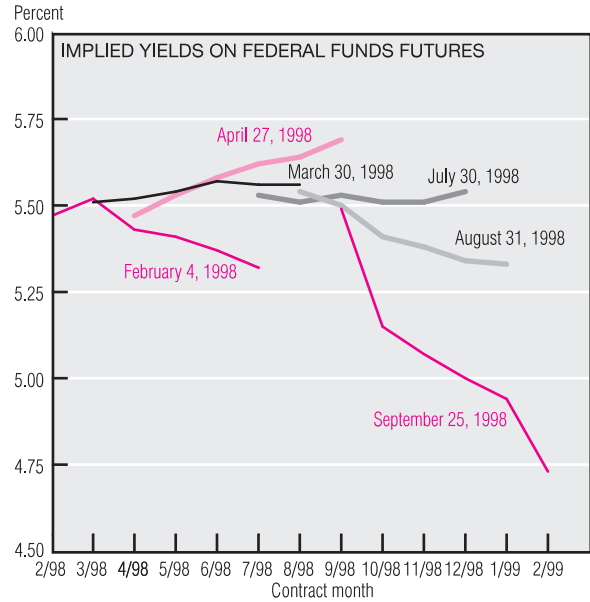
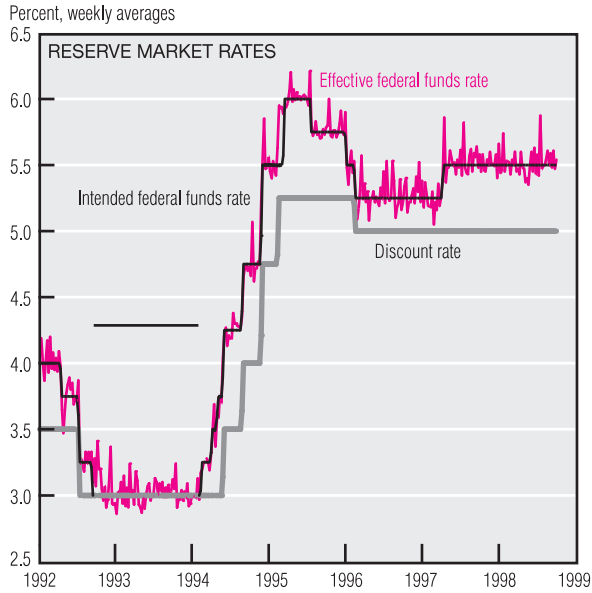
M2 growth continues to outstrip the upper bound of its 1% to 5% provisional range, having grown year-to-date (using its September estimated value) at a 7.75% annualized rate.

MZM has grown at a rate exceeding 12% year-to-date through September; it has also approached the most rapid growth of more than 17% (annualized rate) from August to September, after growing at a 14% annual rate from July to August. MZM's rapid growth from August to September is attributable to increases in

savings deposits and money market mutual funds. Increased savings deposits, in turn, may result from the high volatility and precipitous fall of equity prices in recent months. Savings deposits are certainly a more stable short-term location for one's money than the stock market. Similar justification could be given for the rise in money market mutual funds. These funds have been called a parking lot for money taken out of the stock market. It can also be argued that an increase in money market accounts has been

(continued on next page)

Monetary Policy (cont.)



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

required to provide the necessary liquidity for the higher volume of equity trading.

The federal funds rate has remained relatively stable around the target effective rate of 5.5% set in March 1997. However, the notion that a funds rate drop will be enacted in the foreseeable future seems to be widespread. Implied yields on federal funds futures indicate that traders in that market anticipate a softening of policy on the order of 50 basis points by the end of the calendar year and more than 75 basis points before the end of 1999:1Q.

Both long- and short-term inter-

est rates have fallen off recently. During the week of August 18, the weekly average interest rate on the 30-year Treasury bond (constant maturity) fell below 5.5% for the first time since the constant maturity measure's inception in 1977. In that same week, conventional mortgage rates dropped beneath their previous low of 6.74%, which was reached the week of October 22, 1993.

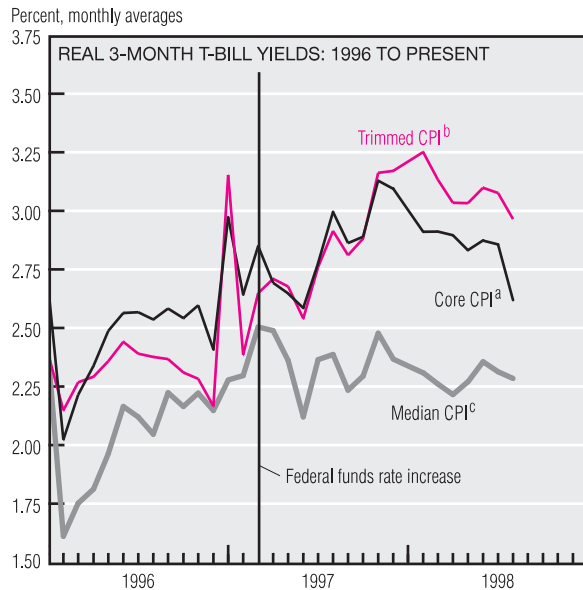
Although they are not approaching such record-low levels, short-term interest rates have been falling quickly as well. The constant maturity rates on the 1-year and 3-month Treasury bills converged at a level

of about 4.75%. This represents a drop-off in the weekly average of over 60 basis points in seven weeks for the constant-maturity, 1-year T-bill rates, and a fall of almost 35 basis points in the same period for the weekly average of constant-maturity, 3-month T-bill rates.

Some observers claim that over the past year or so, the Federal Reserve has effectively tightened monetary policy by leaving the federal funds rate unchanged in the face of a drop in inflation. That is, the Fed has allowed an increase in the real interest rate—the nominal interest rate less inflation. It is cer-

(continued on next page)

Monetary Policy (cont.)



- a. CPI less food and energy.
 b. 16% trimmed mean CPI.
 c. Weighted median CPI.

SOURCE: Board of Governors of the Federal Reserve System.

Comparison of Real 3-Month T-Bill Yields
 (Percent, monthly averages)

Average for	Core ^a	Trimmed ^b	Median ^c
1998	2.73	2.96	2.15
1968–98	1.31	1.54	1.43
1988–98	1.77	1.97	1.80
Difference, 1998 versus			
1968–98	1.42	1.42	0.72
1988–98	0.96	0.99	0.35

tainly clear that the real interest rate tends to be low during periods of loose monetary policy (for example, the mid- to late 1970s) and high when policy is tight (the early to mid-1980s).

However, using the real interest rate to argue that the Fed has recently tightened policy depends crucially on how inflation is measured. For example, using the core CPI (CPI excluding food and energy) to measure inflation shows a run-up in the real interest rate following the last federal funds rate increase in March 1997. For 1998, this measure of the real interest rate

is 1.42 percentage points higher than its average value for the 1968–98 period and 0.96 percentage point above its average for the 10 years ending August 1998.

Like the core CPI, the 16% trimmed mean CPI excludes the CPI's more volatile components. Again, the increase in the real interest rate following the federal funds rate increase in March 1997 can be readily seen. The behavior of this real interest rate is generally similar to that of the core CPI.

Research at the Cleveland Fed indicates that the median CPI is a better measure of the underlying

inflationary process than either the core CPI or the 16% trimmed mean CPI. Since March 1997, this measure of the real interest rate has been relatively unchanged. Furthermore, its average value for 1998 is 0.72 percentage point higher than its average for 1968–98 (half that of the other measures) and only 0.35 percentage point higher than its average for the past 10 years (roughly one-third of the other measures). On the basis of the median CPI, it would be difficult to argue that policy has tightened over the past year and a half.