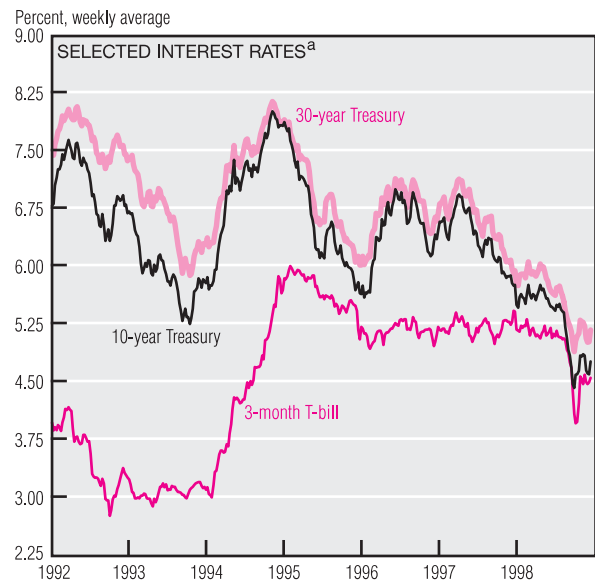
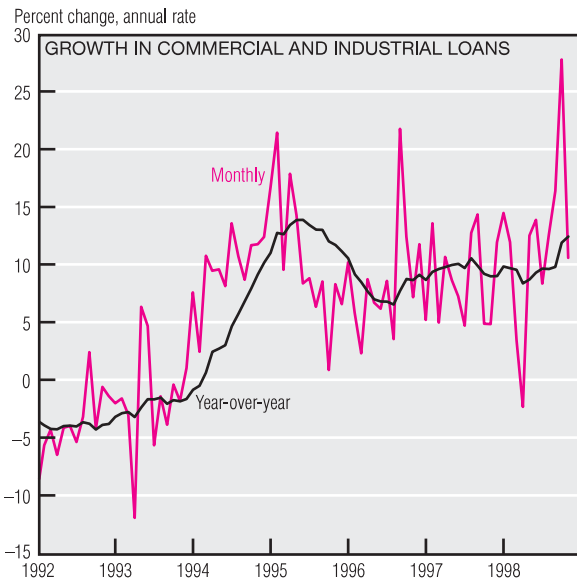
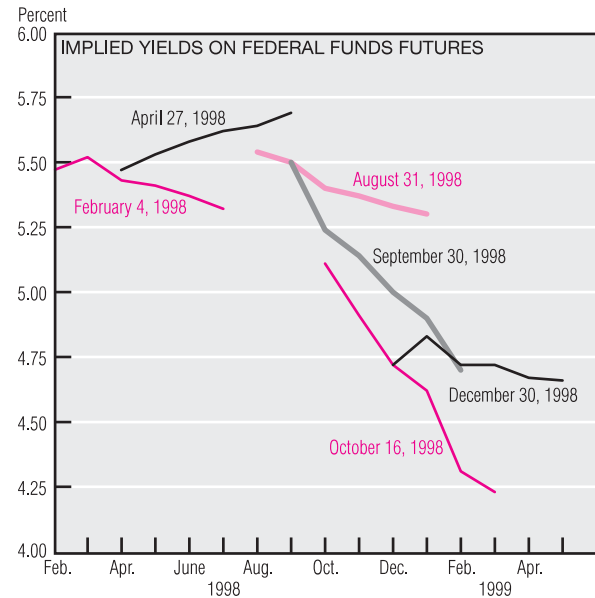
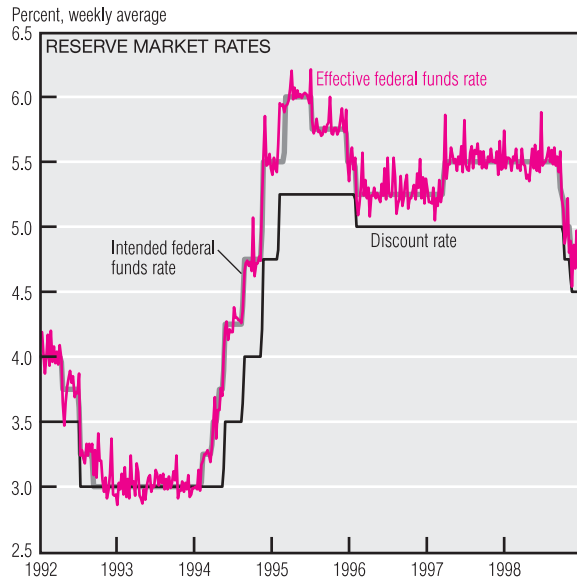


Monetary Policy



a. Constant maturity.

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

The autumn of 1998 was the most active season for monetary policy in several years. In the span of seven weeks, the Federal Open Market Committee (FOMC) lowered its target for the federal funds rate in three decrements of 25 basis points each—two at scheduled meetings in September and November and one in the intermeeting period. The latter two changes were coupled with commensurate reductions in the discount rate. At its last meeting on December 22, the FOMC did not alter the intended fed funds rate.

The spate of policy actions was not fully anticipated. In April, the predominant expectation was that the FOMC's next move would be to increase the funds rate. By late August, futures prices of fed funds implied an expectation that the next policy move would be a decrease, but the immediacy of the three actions was a surprise, even by late September.

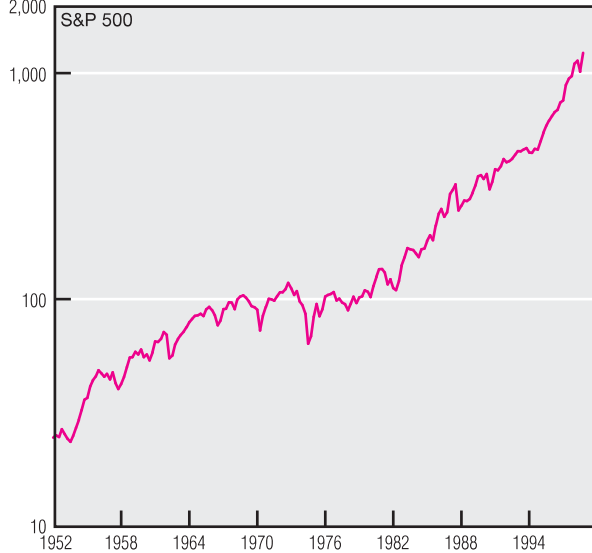
Evidence of surprisingly strong domestic spending in early 1998 suggested that the potency of U.S. domestic spending was sufficient to offset any threat posed by the

economic turmoil in Asia. Over the summer, however, signs of the mid-August financial crisis in Russia began to emerge and led to growing concern that Russia's problems would spread to emerging markets. By early September, FOMC Chairman Alan Greenspan warned, "it is just not credible that the United States economy can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress."

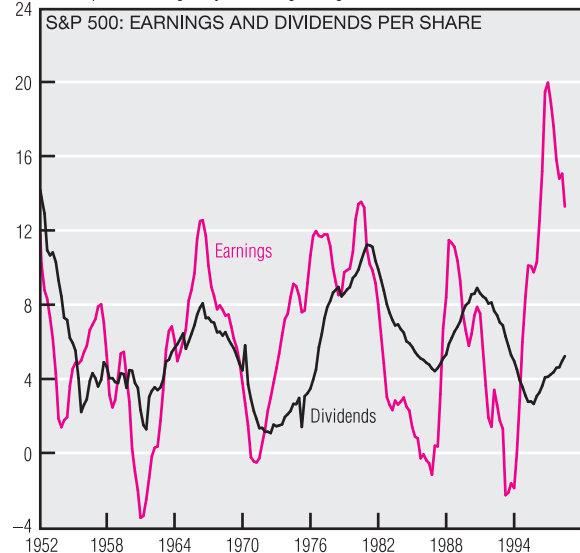
Fears about potential contagion effects of the Russian political and economic turmoil, particularly on
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Monetary Policy (cont.)

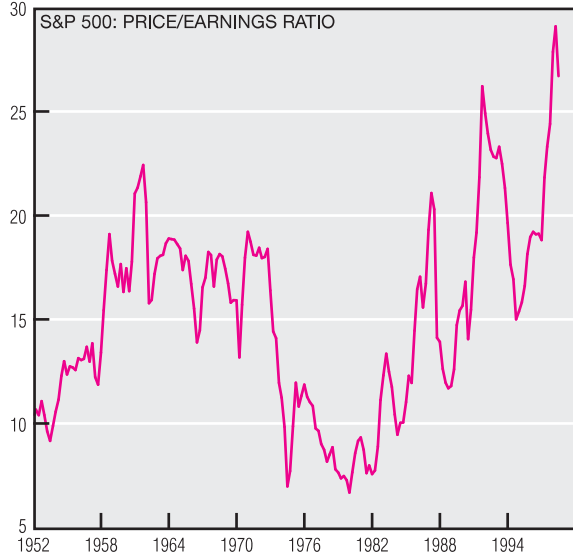
Index, 1941–1943 = 10.0 (log scale)



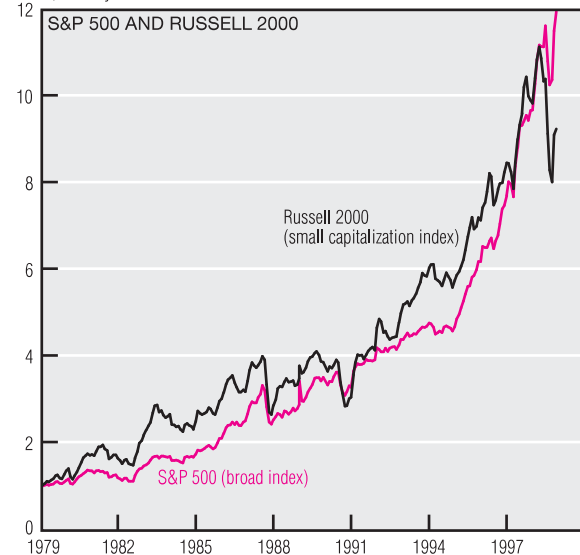
Annualized percent change, 5-year moving average



Ratio



Index, January 1979 = 1.0



SOURCES: Standard and Poor's Corporation; and DRI/MCGraw-Hill.

Latin American markets, induced a flight to quality. Increased foreign demand for U.S. Treasury securities depressed rates paid on these instruments. Liquidity concerns in the commercial paper market forced many U.S. firms to draw on their lines of bank credit.

On August 31, the S&P 500 plunged 69.86 points, its worst single-day point decline ever. The index found a new low in early fall after news emerged about liquidity problems experienced by a high-profile hedge fund, but then it staged an astounding comeback. On December 29, the S&P 500 ended the year

up 26.7% at 1,229.23. The autumn policy actions appear to have assuaged the worst fears in financial markets.

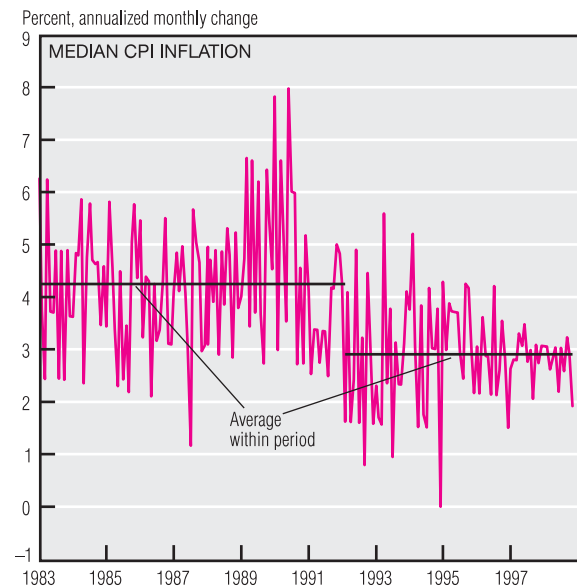
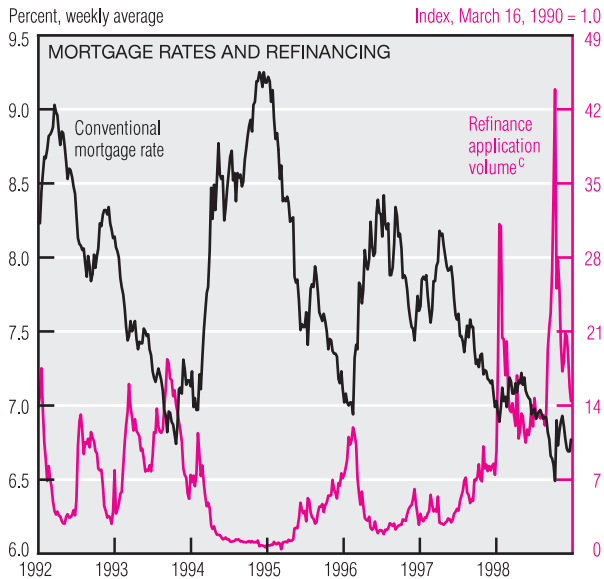
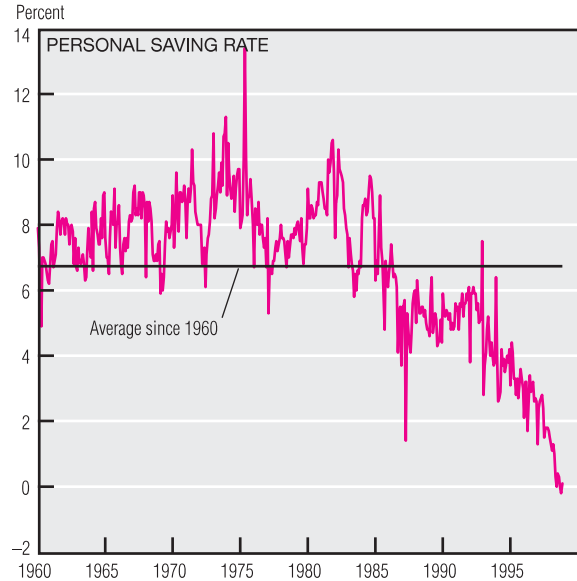
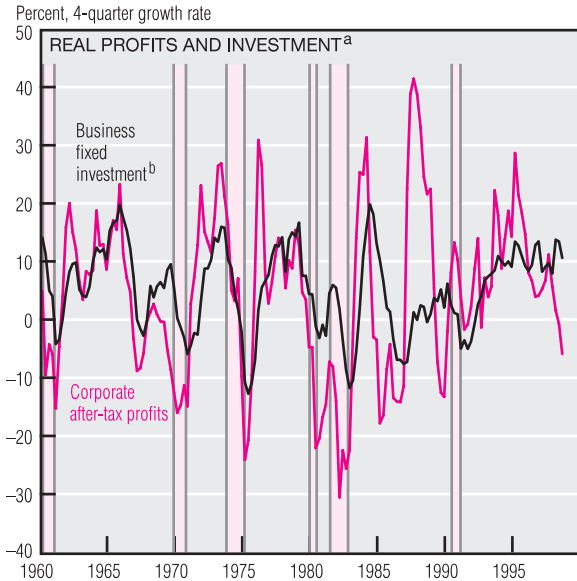
Current levels of U.S. stock prices indicate a degree of optimism some find difficult to reconcile with the state of the world economy. Fundamentally, a stock's price equals the discounted value of its expected future dividends. Because future dividends derive from future earnings, expected earnings must be very strong. The price/earnings ratio—simply the stock price divided by the earnings per share—gives investors an idea of how much they are paying for a company's earning power. The

recent record-high P/E for the S&P 500 index suggests that investors expect strong earnings growth to continue well into the future for the largest U.S. companies.

The Russell 2000 index of stocks with capital values under \$1.4 billion, however, barely recouped its August and autumn losses and was down slightly for the year. Thus, investors remain concerned, at least at this level. Moreover, broad measures of earnings, such as after-tax profits of nonfarm corporations, also reveal a less sanguine picture. Over the past several years, such profits have helped

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Monetary Policy (cont.)



a. Shaded areas indicate recessions.

b. Business fixed investment of nonfarm nonfinancial corporations, adjusted by 1992 chain-weighted implicit price deflator for nonresidential fixed investment.

c. Seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and DRI/McGraw-Hill.

to finance an investment boom, but recent declines have raised questions about the continuation of strong investment spending. Business fixed investment growth has exceeded profit growth over the past year. Such conditions are often associated with economic downturns.

Questions about the sustainability of consumer spending are also a source of concern. Consumer confidence is believed to be driven largely by increased employment opportunities and large wealth

gains attributable to elevated equity values. By one measure—the personal saving rate—households are so confident that they are willing to spend more than their earned income. In October and November, the personal saving rate was negative for the first time ever. If stock prices were to tumble and then remain low, it is doubtful that consumers would continue this trend.

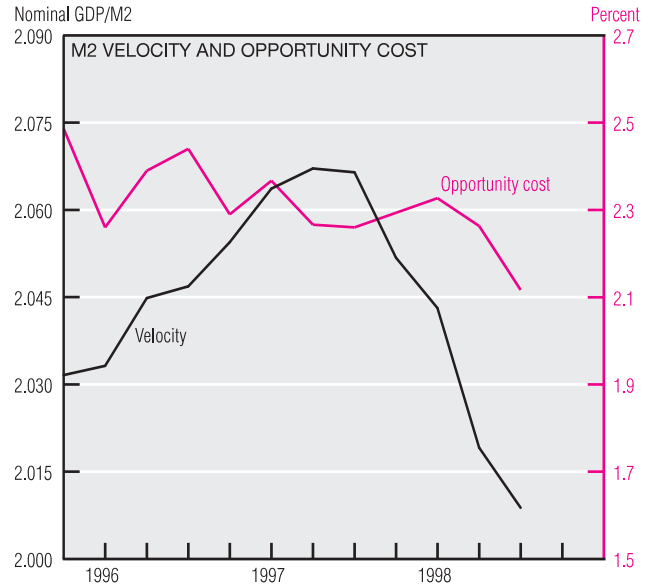
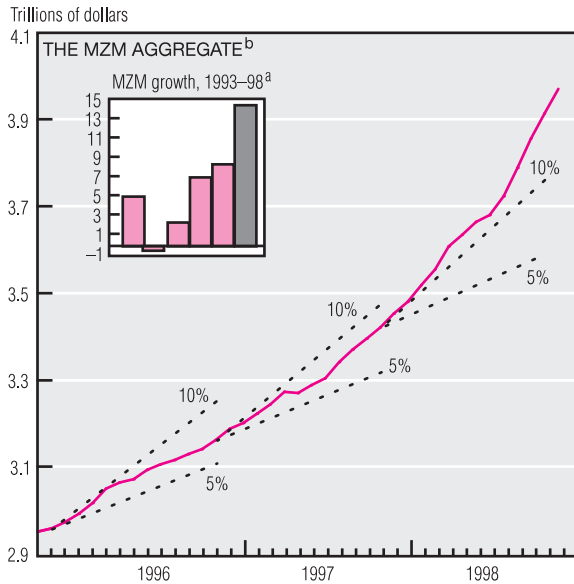
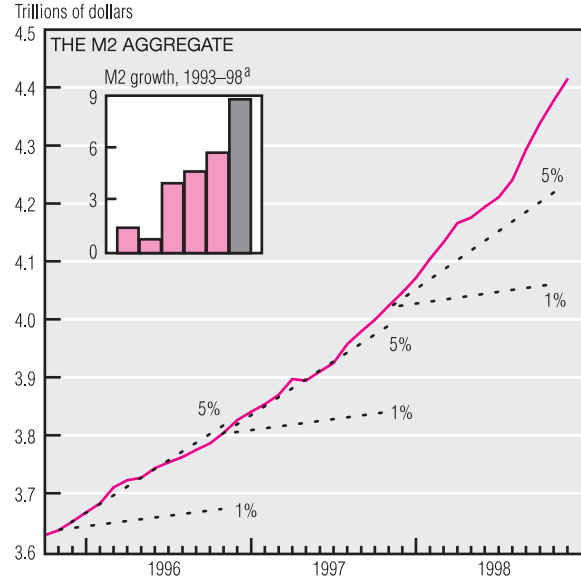
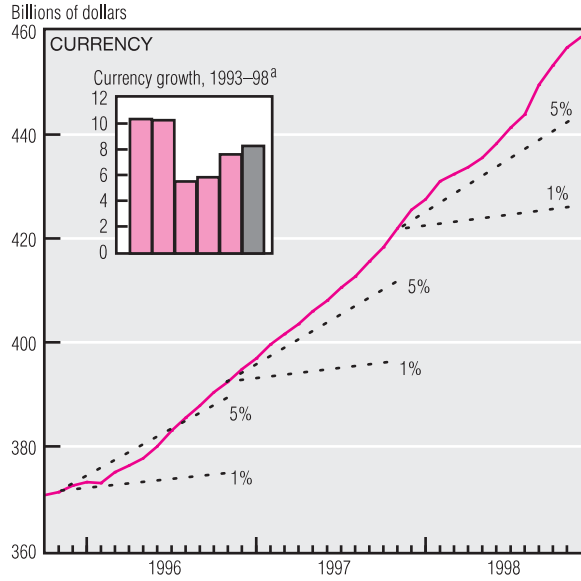
A chief source of liquidity for households has been home equity: Falling mortgage rates have induced many families to refinance their

homes, and lower mortgage rates allow them to tap into home equity without adding to mortgage payment flows. This source of liquidity would diminish if inflation were to accelerate, thereby leading to higher long-term interest rates.

Indeed, a key factor accommodating continued expansion is the absence of clear signs of accelerating inflation despite rapid money growth. Thus far, it is difficult to refute those pundits who consider recent economic performance a permanent con-

(continued on next page)

Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. 1998 growth rates calculated using 1998:IVQ with estimated December data.
 b. MZM is an alternative measure of money that is equal to M2 plus institutional money market mutual funds less small time deposits.
 NOTE: Data are seasonally adjusted. Last plots for M2 and MZM are estimated for December 1998; last plot for currency is an average of weekly figures available for December 1998. Dotted lines for M2 are FOMC-determined provisional ranges. Dotted lines for currency and MZM represent growth in levels and are for reference only.
 SOURCES: Board of Governors of the Federal Reserve System.

dition of more rapid output supply. Evidence is found in rapid productivity growth, averaging about 2¼% over the past three years, and in workers' willingness to increase hours for moderate gains in compensation. How long these positive supply surprises will continue is a critical issue for enduring optimism.

Regardless, money measures like M2 and MZM continue to grow at rates exceeding nominal output. This has led some observers to speculate that rapid money growth is financing a stock market bubble. Nobel laureate

Milton Friedman, for example, finds it hard to believe that stock prices are sustainable at current levels. Price measures that include asset prices rather than just goods and services have accelerated to higher growth rates since 1995, suggesting that acceleration in money growth may be inducing inflated asset prices.

A more hopeful explanation for the recent surge in money growth is that it reflects increases in the demand for money. Some research shows that investors demand more liquidity during periods of stock price vari-

ability comparable to that experienced over the past year. More specifically, investors use money market mutual funds (MMMFs) as a gateway for financial transactions, swelling MMMF growth during such periods. Mortgage refinancings are also associated with transitory increases in money growth. If these explanations are correct, then one might expect to see money growth drop sharply in 1999. Only time will resolve the puzzle concerning the ultimate outcome of recent money growth.