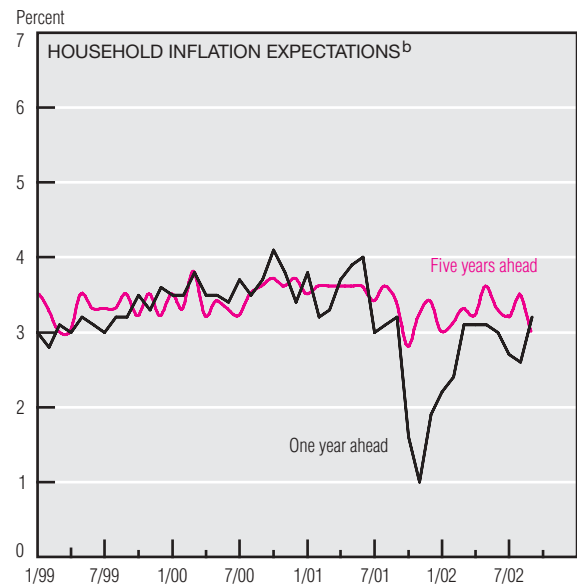
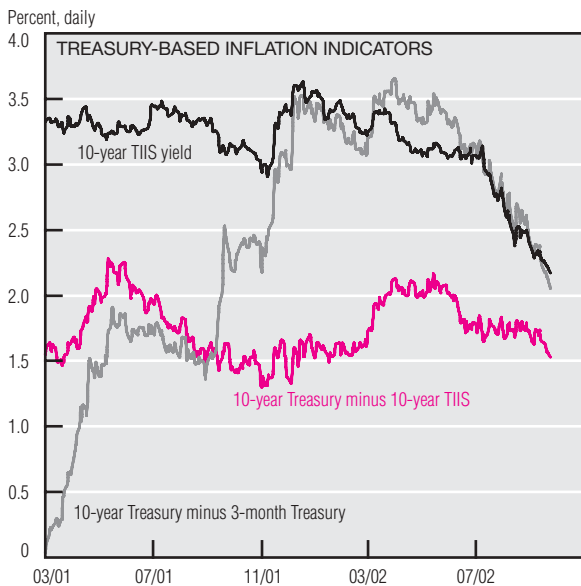
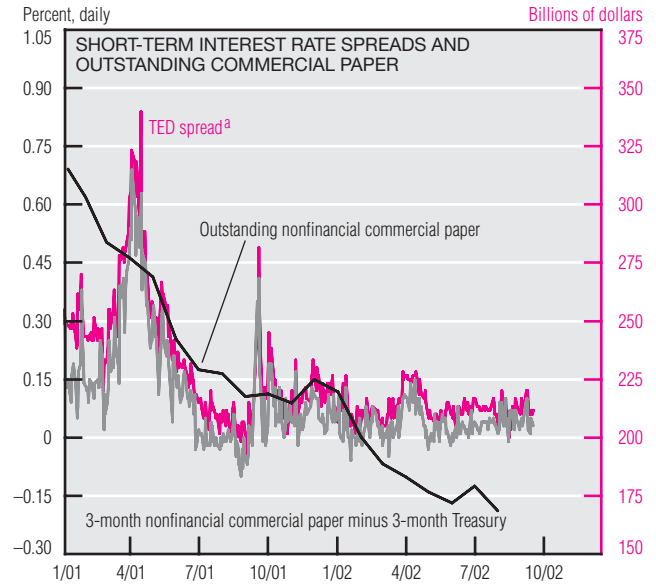
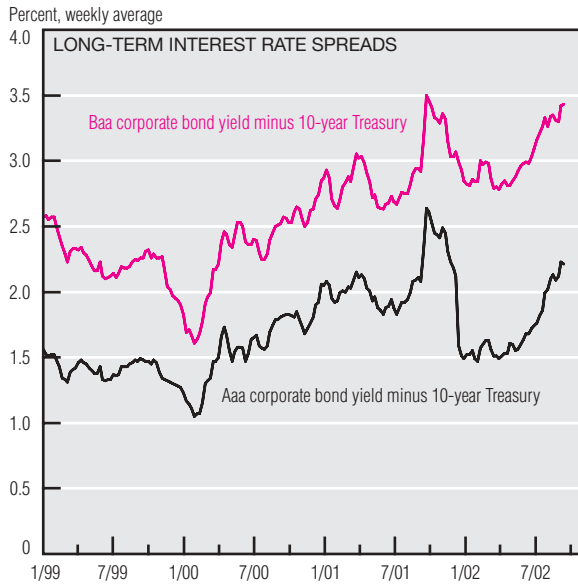


Money and Financial Markets



NOTE: All Treasuries shown are constant maturity.

a. Three-month rate on eurodollar deposits minus three-month Treasury bill yield.

b. Mean expected change in consumer prices as measured by the University of Michigan *Survey of Consumers*.

SOURCES: Board of Governors of the Federal Reserve System; Bloomberg Financial Information Services; and University of Michigan.

The spread between corporate and government interest rates typically rises during recessions and then declines when the recovery gets under way. Although many consider the recession to be over, long rate spreads have risen more than 50 basis points (bp) so far this year, despite a drop of about 50 bp in AAA- and BAA-rated corporate bonds. This decline, however, has been more than offset by the fall in the 10-year Treasury rate. On the other hand, the spread between

three-month commercial paper and the three-month Treasury bill has remained fairly flat in 2002 so far, with little movement in either rate.

One possible explanation for the drop in long rates is that the real interest rate has fallen. This explanation is confirmed by a fall in the 10-year Treasury inflation-indexed securities (TIIS) yield, which is a real interest rate.

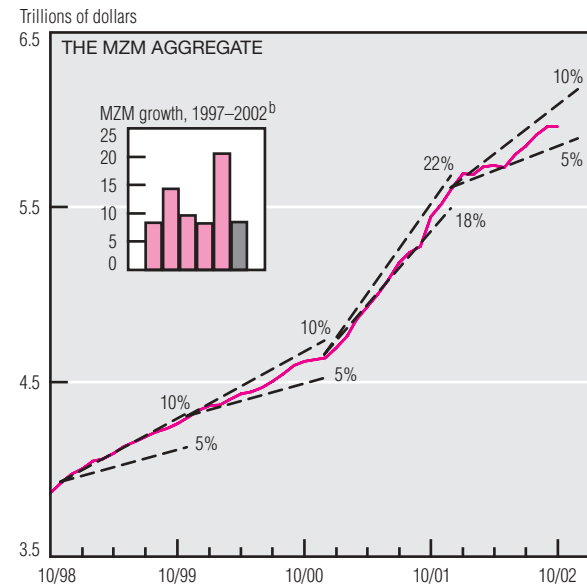
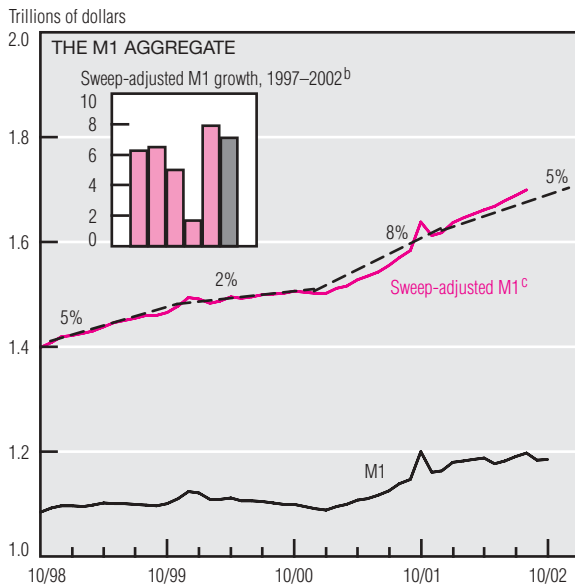
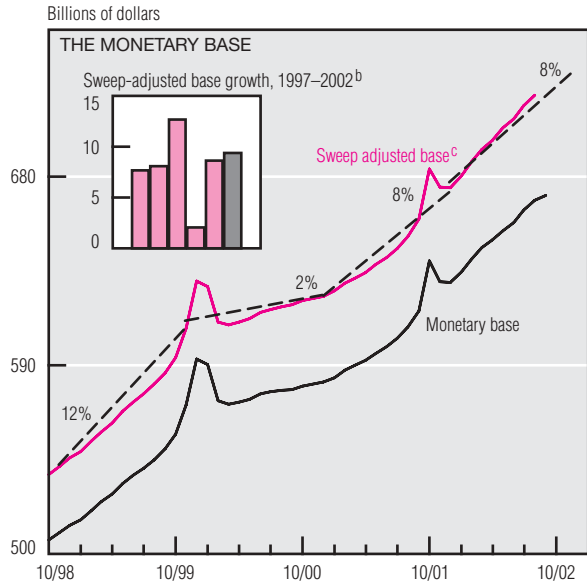
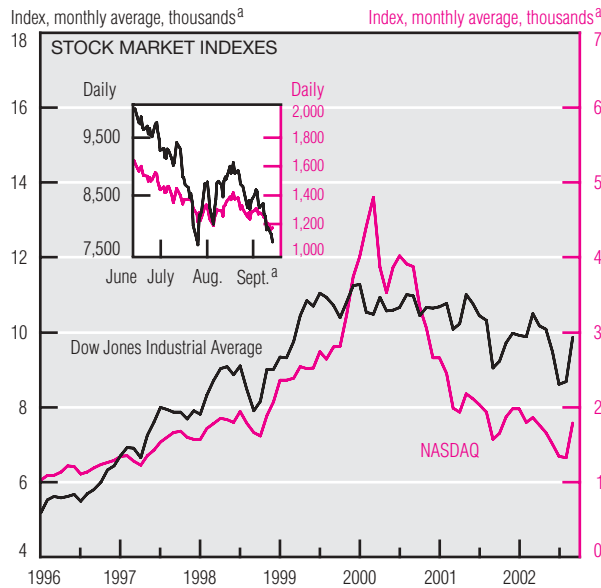
Alternatively, the fall in long rates could result from lower inflation expectations, but there is scant

support for this view. First, the spread between the 10-year Treasury rate and the 10-year TIIS yield, a fairly direct measure of the expected inflation rate for the next 10 years, has not changed much since the start of the year. Second, the University of Michigan survey of household inflation expectations shows little change at either the one- or the five-year horizon.

Stock prices have dropped in tandem with real interest rates, a surprising relationship at first glance

(continued on next page)

Money and Financial Markets (cont.)



a. Monthly average through September 24.

b. Growth rates are calculated on a fourth-quarter over fourth-quarter basis.

c. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts.

SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg Financial Information Services.

because standard asset-pricing theory predicts that a stock's price should equal the present discounted value of its dividends. A fall in the real interest rate implies that future dividends will be less heavily discounted, which would increase stock prices. These prices would then be expected to increase more slowly because the return on holding stocks after adjusting for risk should roughly equal the return on bonds or the real interest rate. Most

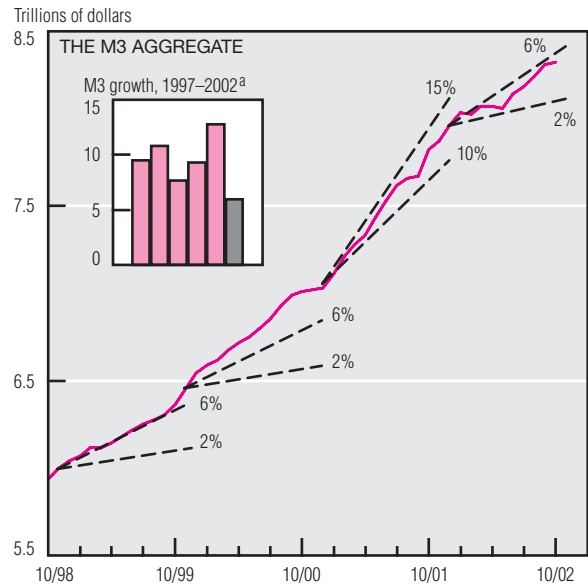
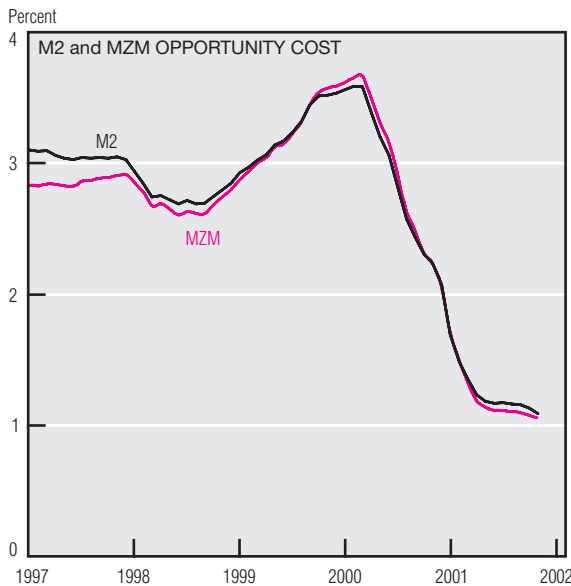
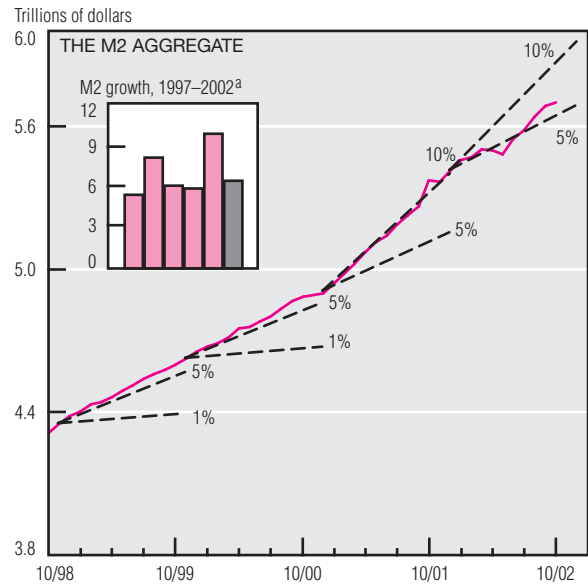
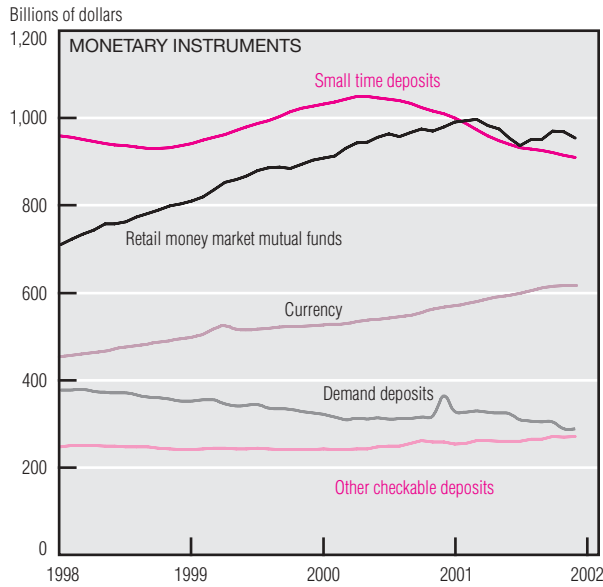
likely, the economy's continuing weakness, evidenced by the decline in the rate spread between the 10-year and the three-month Treasuries in 2002, has pushed down both real interest rates and stock prices. In September, the Dow Jones Industrial Average hit a four-year low, and the NASDAQ a six-year low.

The longer-term inflation outlook may also be gauged by the monetary aggregates, which present a mixed picture of future inflation. The

growth rates for the narrow aggregates, such as the sweep-adjusted base and sweep-adjusted M1, are roughly 1.5 percentage points above their five-year averages, and both exceed nominal income's current growth rate. The increase in M1 growth resulted from a 7.2% increase in currency (52% of M1) and a 5.9% increase in other checkable deposits, offsetting a 12% decline in demand deposits (24% of

(continued on next page)

Money and Financial Markets (cont.)



a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.
SOURCE: Board of Governors of the Federal Reserve System.

M1). This strong growth suggests an upsurge in future inflation.

Money of zero maturity (MZM) has grown 8.5% so far this year. While this may seem robust, it is lower than the 20.5% growth of 2001. Recent strong growth reflects a drop in its opportunity cost (the difference between rates on three-month Treasury bills and the share-weighted rates of return on MZM's components). Historically, such pat-

terns of money growth have been portents of future inflation.

The broader M2 monetary aggregate has grown at more moderate rates, 10.3% in 2001 and an annualized 6.7% so far this year. This slower growth results from declines in retail money-market mutual funds (8%) and small time deposits (4%), which have more than offset the rise in M1 growth and savings deposits, the second of which has advanced 17%. As with MZM, the fall in M2

growth also reflects a drop in its opportunity cost, the return paid on M2 deposits. An even broader aggregate, M3, includes M2 plus large time deposits, eurodollars, and repurchase agreements. The M3 growth rate has been 5.95% so far this year, much the same rate as M2. Growth in the broader aggregates is more in line with that of nominal income, suggesting that inflation may not be a problem going forward.