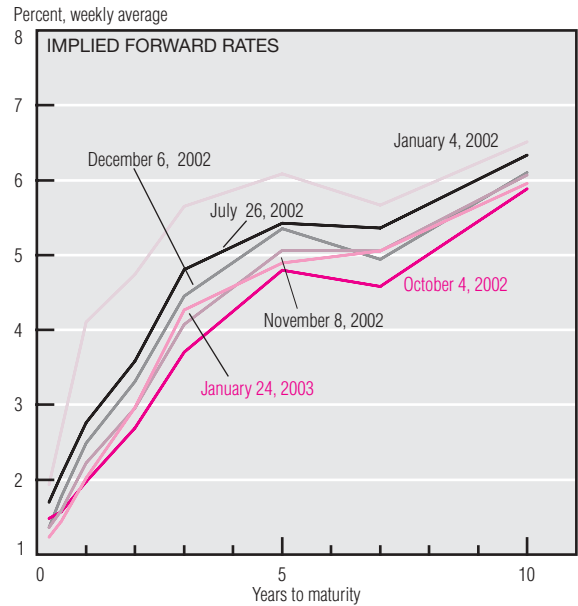
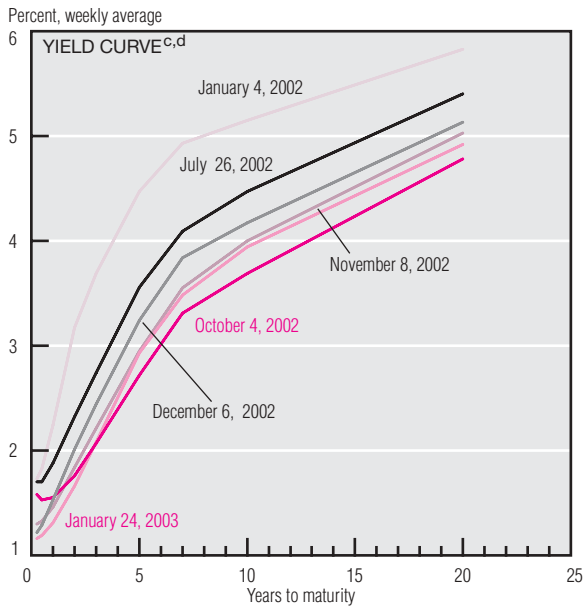
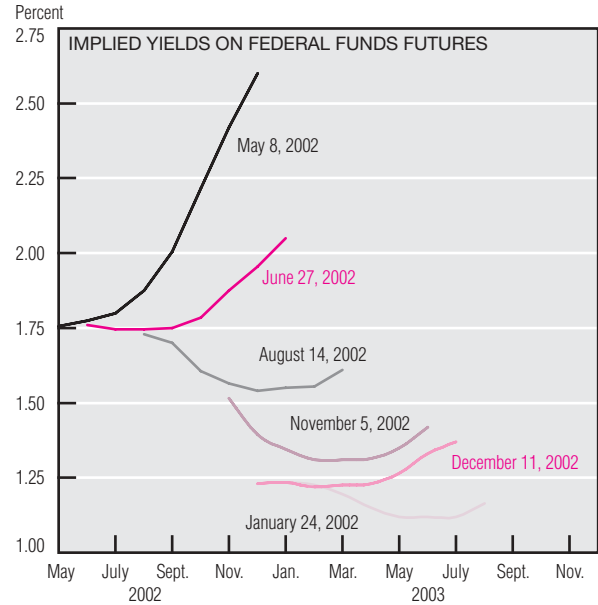
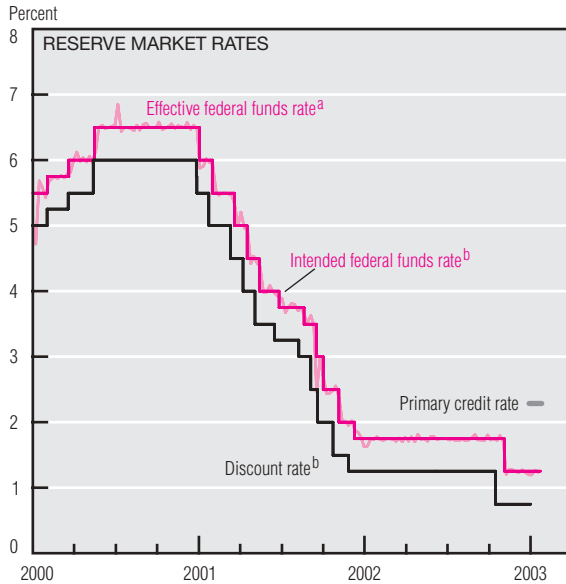


Monetary Policy



- a. Weekly average of daily figures.
 b. Daily observations.
 c. Average for the week ending on the date shown.
 d. All yields are from constant-maturity series.
 SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

As of January 9, 2003, instead of the discount rate, Federal Reserve Banks began to offer depository institutions two discount window programs: primary credit and secondary credit. Primary credit loans are extended for a very short term (usually overnight) to depository institutions in generally sound financial condition. This rate (currently 2.25%) will initially be 100 basis points (bp) above the target federal funds rate set by the Federal Open Market Committee (FOMC). Depository institutions not eligible for primary credit may apply

for secondary credit, which will initially be set 50 bp above the primary credit rate.

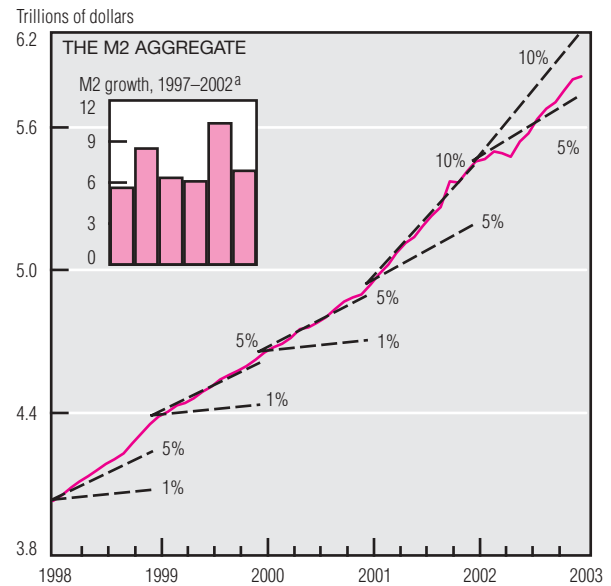
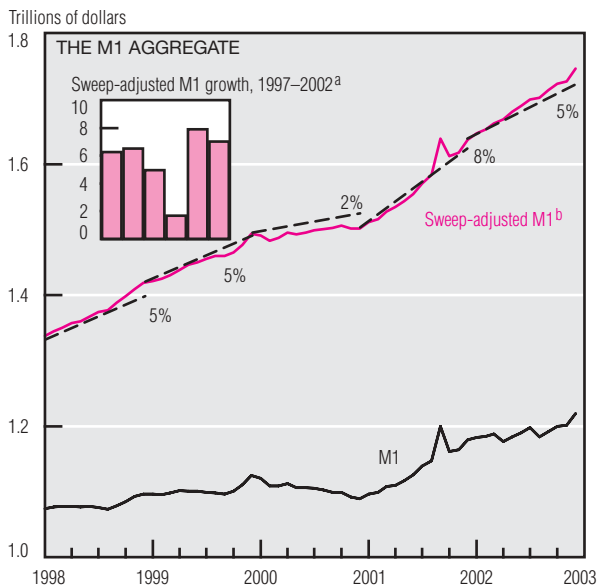
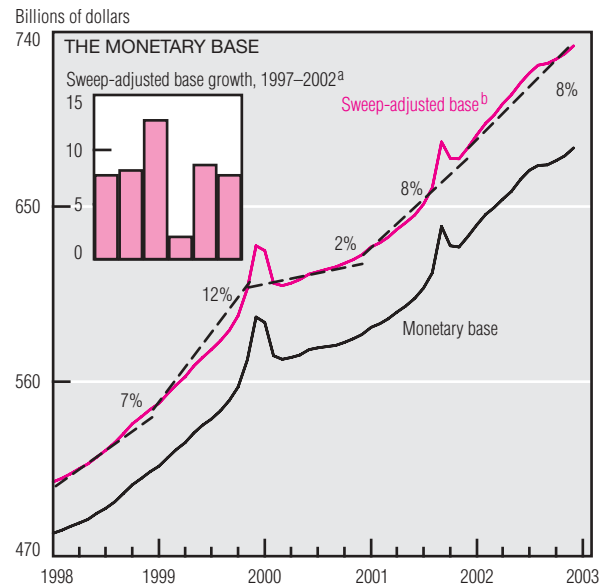
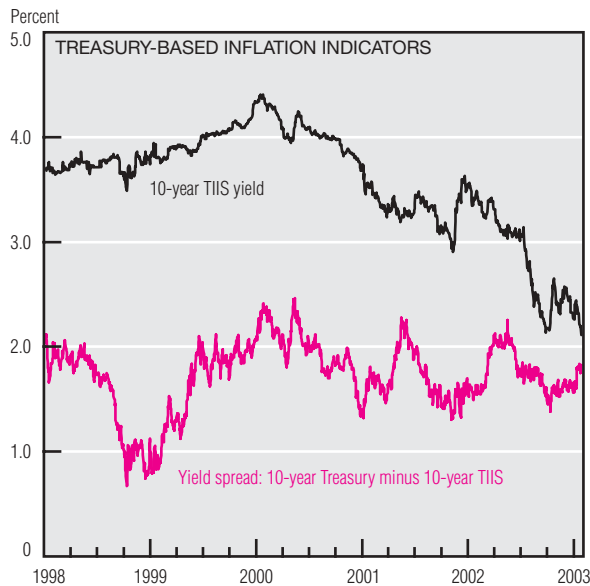
At its January 28–29 meeting, the FOMC left the intended federal funds rate unchanged at 1.25%. As of January 24, the federal funds futures' June contract traded at 1.12%, 13 bp below the current federal funds rate target, suggesting that market participants are betting the next change will be down.

Long-term rates respond to changes in inflationary expectations. Since last July, the yield curve has

shifted down at both the short and the long end. Long-term rates are an average of current and implied future short-term rates. Implied forward rates have fallen since July, suggesting that long-term inflationary expectations have dropped. Since December, long-term rates have fallen and short-term rates have been essentially unchanged. Both long-term and implied forward rates suggest that long-term inflationary expectations continue to fall.

(continued on next page)

Monetary Policy (cont.)



a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.

b. 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, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

Another way to gauge long-term inflation expectations is by subtracting the yield on 10-year Treasury inflation-indexed securities (TIPS), a signal of the real rate of interest, from the 10-year Treasury bill. This measure of the average inflation rate that is expected to prevail over the next 10 years has changed little in the last 18 months.

Money is the primary driver of inflation, but it is unclear which money measure is the best. The monetary base represents the liabilities of the

Federal Reserve and, although noisy, it is arguably the best measure of monetary policy. If the funds rate is held below short-term market rates, base growth tends to rise. The sweep-adjusted monetary base currently is rising at 7.7% per year. Its growth accelerated in mid-2000 and subsequently has been fairly stable. Its acceleration corresponds roughly with the beginning of rate cuts in early 2000, which suggests that monetary policy eased unambiguously with the initial cuts. Since then, however, the Federal Reserve has lowered the funds rate

substantially, but this has followed other market interest rates and may not truly reflect an easing of monetary policy.

The broader monetary aggregates sometimes track future inflation more closely. Sweep-adjusted M1 rose at a steady pace over 2002, ending the year at 7.0%. M2 slowed from its rapid growth of 10.3% in 2001 to 6.9% in 2002. The number for January 2003 probably will indicate further slowing and should come in below 0%.