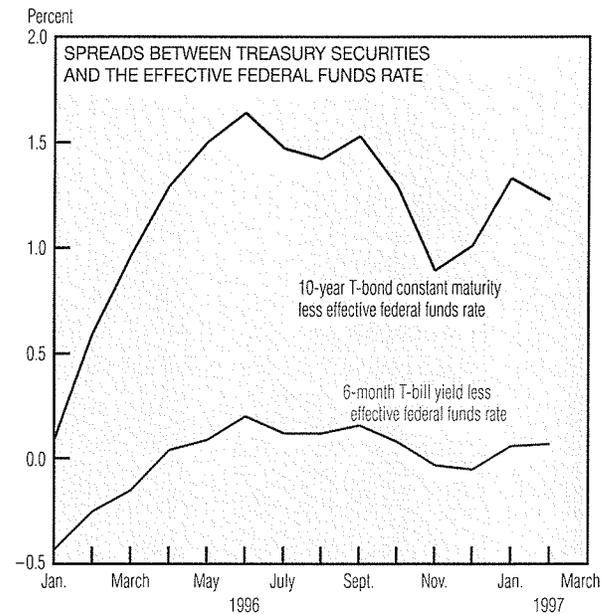
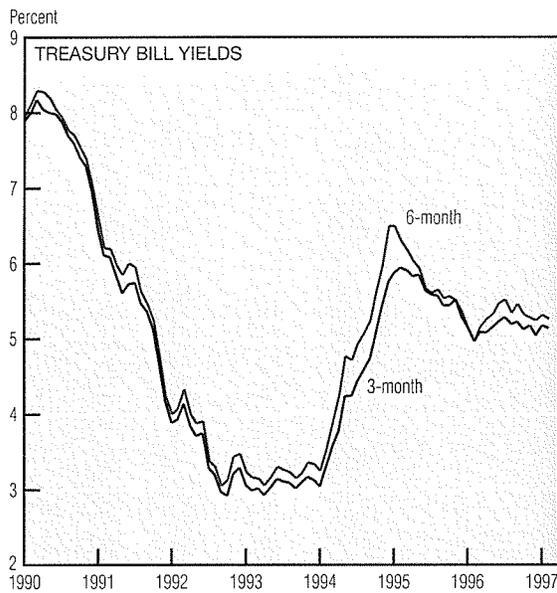
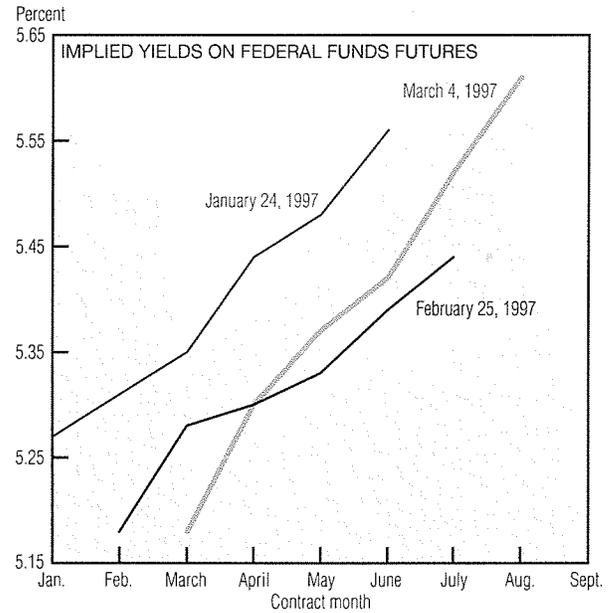
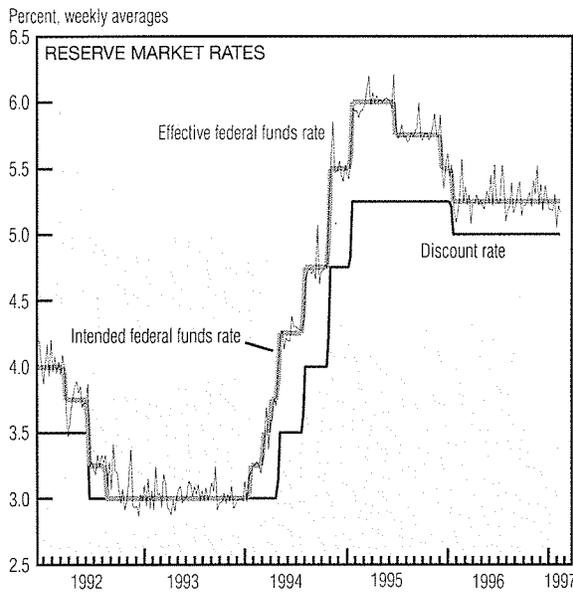


Monetary Policy



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

Mention monetary policy, and the first thing that many people think of is the federal funds rate. Thus, to the extent that the behavior of the funds rate is truly synonymous with monetary policy, the news from the latest meeting of the Federal Open Market Committee (FOMC) is no news: Subsequent to that meeting, the federal funds rate has remained in the 5-1/4% neighborhood where it has resided since January 1996.

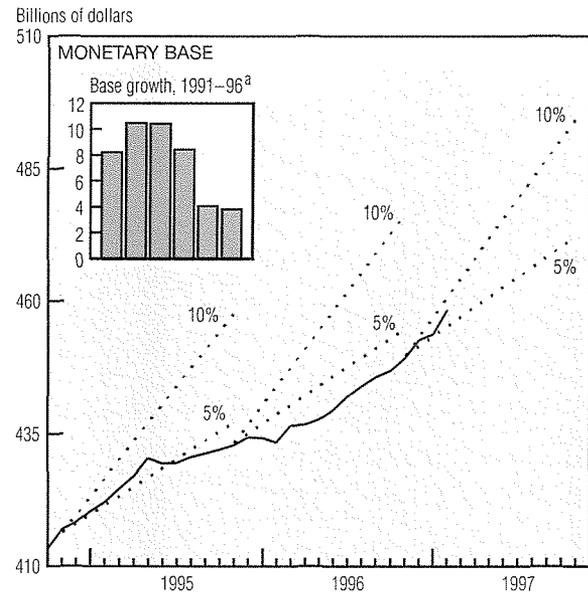
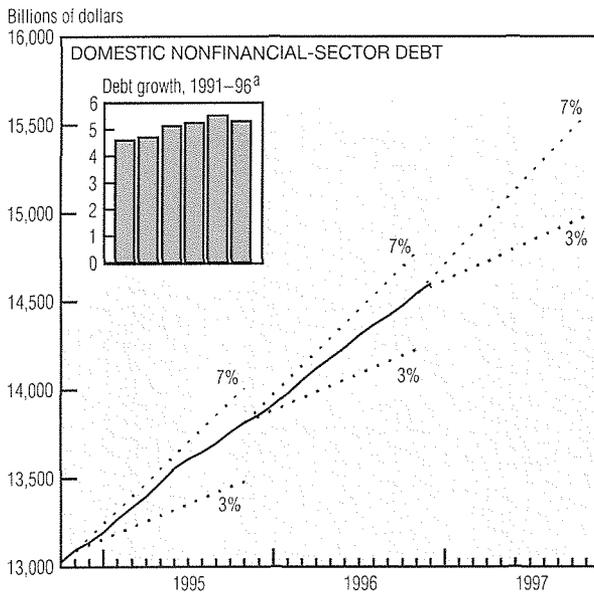
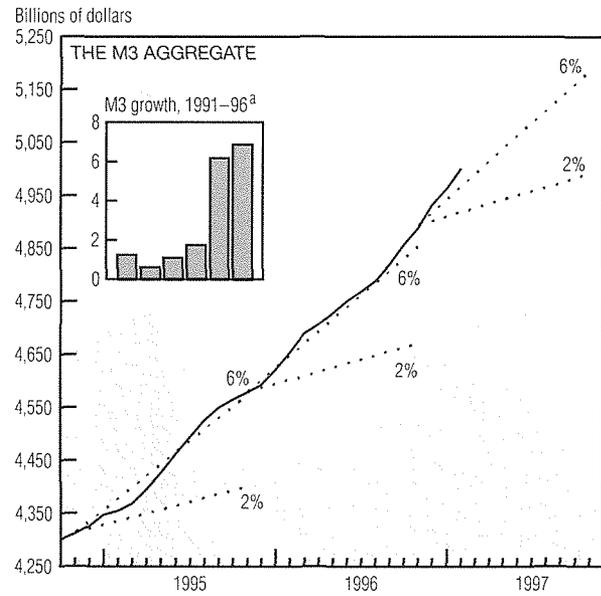
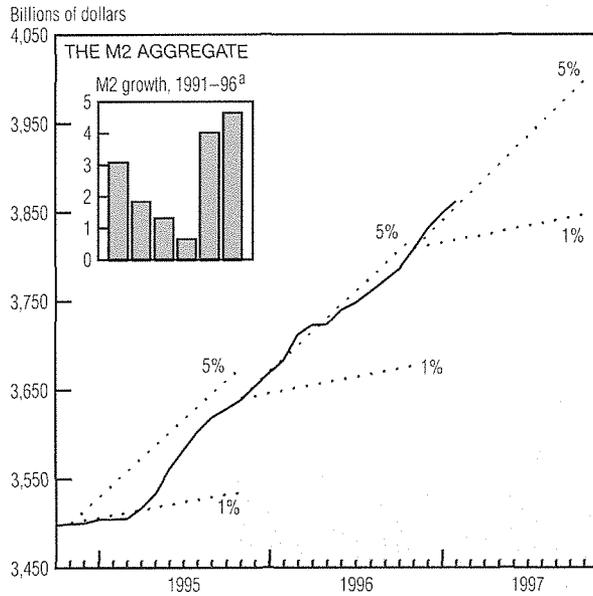
It is clear that market observers do not expect this stability to persist indefinitely. Implied yields on fed-

eral funds futures, which reflect expectations of future policy, suggest that investors are anticipating higher rates as the year proceeds. Although such expectations have in the past proved far from infallible—the higher rates expected to materialize during 1996 never did—the belief that a rate hike is imminent was undoubtedly bolstered by Chairman Greenspan's recent reminder that the "FOMC in fact has signaled a state of heightened alert for possible policy tightening since last July in its policy directives."

It bears noting that the absence of a federal funds rate change does not necessarily imply a constant monetary policy. A growing gap between market rates and the funds rate is likely to require changes in the growth rate of bank reserves supplied by the Fed, which in turn implies a change in the growth rates of the broader measures of money. No compelling sign of any such gap has developed, but it is worthwhile to remember that monetary policy is ultimately about the rate at which

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Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.
 NOTE: All data are seasonally adjusted. Last plot is estimated for February 1997. For the monetary base, dotted lines represent growth ranges and are for reference only. All other dotted lines are FOMC-determined provisional ranges.
 SOURCE: Board of Governors of the Federal Reserve System.

the money supply expands, not about a narrow interbank interest rate (the federal funds rate) that monetary authorities employ to monitor money growth.

The FOMC chair's semiannual report to Congress, typically referred to as the Humphrey-Hawkins testimony, still reflects the fact that monetary policy is about money. As part of his report of February 26, Chairman Greenspan noted that "at its February meeting, the FOMC reaffirmed the provisional ranges set last July for money and debt growth this

year: 1 to 5 percent for M2, 2 to 6 percent for M3, and 3 to 7 percent for the debt of domestic nonfinancial sectors."

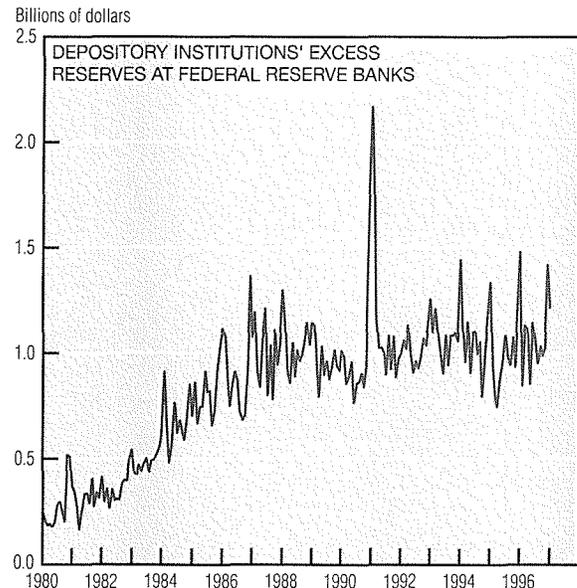
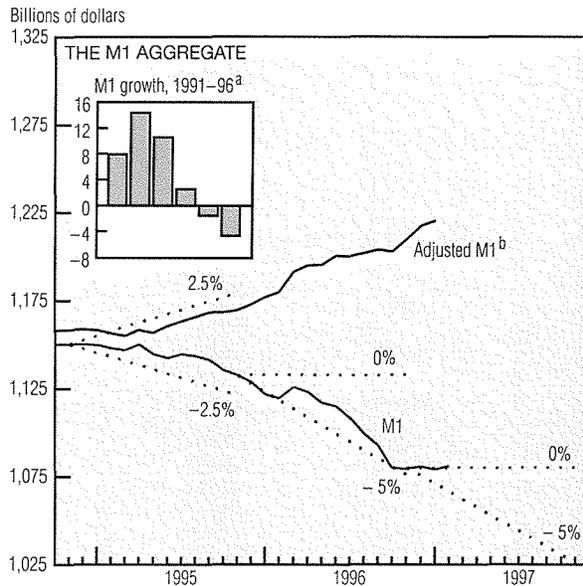
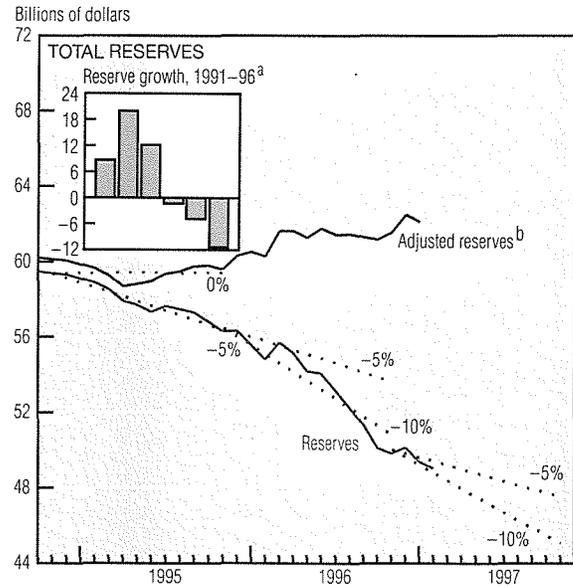
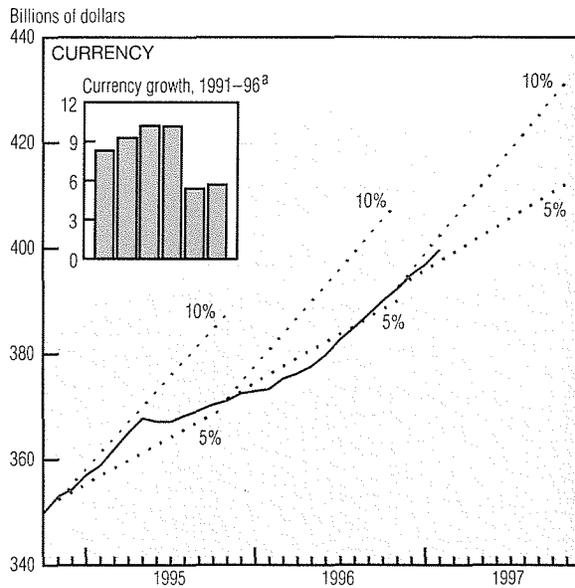
Although the Humphrey-Hawkins tradition of reporting monitoring ranges for these broad monetary aggregates continues, it is commonly recognized that the role of these money measures in the ongoing operations of monetary policy has diminished over time. At least part of the problem arises from the fact that measures like M2—which includes such bank liabilities as savings ac-

counts, money market mutual funds, and so on—are relatively far removed from direct control by the monetary authority.

One measure of money more directly under the influence of monetary policy is the monetary base, which consists of currency held by the public plus bank reserves. However, even this measure can be problematic. The prime contributor to base growth in recent years has been currency growth, and it is unclear how much of this is attrib-

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Monetary Policy (cont.)



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

b. Adjusted for sweep accounts.

NOTE: All data are seasonally adjusted except depository institutions' excess reserves at Federal Reserve Banks. Last plots are estimated for February 1997. Dotted lines represent growth ranges and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

able to domestic rather than foreign accumulation. In fact, total reserves have continued to shrink at a rapid pace. Although stabilizing of late, negative reserve growth has shown through to a leveling off in the narrow money measure M1. (M1 consists primarily of currency and checkable deposits.)

The behavior of reserves and M1 over the past several years has generally been attributed to the development of sweep accounts, which allow banks to minimize reserve po-

sitions by short-term "sweeping" of deposits from accounts that require reserves into those that do not. Indeed, after adjusting for sweep activities, the negative trends seen in the nonadjusted data disappear.

Still, this provides little solace given the recognition that reserves are the proximate lever of monetary policy. Developments that have allowed banks to minimize their reserve positions have raised concerns about the Fed's ability to control monetary growth, prompting some

to suggest legislation that would boost the reserves held by banks. However, certain theories suggest that excess reserves, rather than total reserves, are the critical determinants of money growth and monetary control. Here the news may be less threatening; Despite substantial changes in the financial markets, there is little indication that excess reserve levels are changing dramatically.