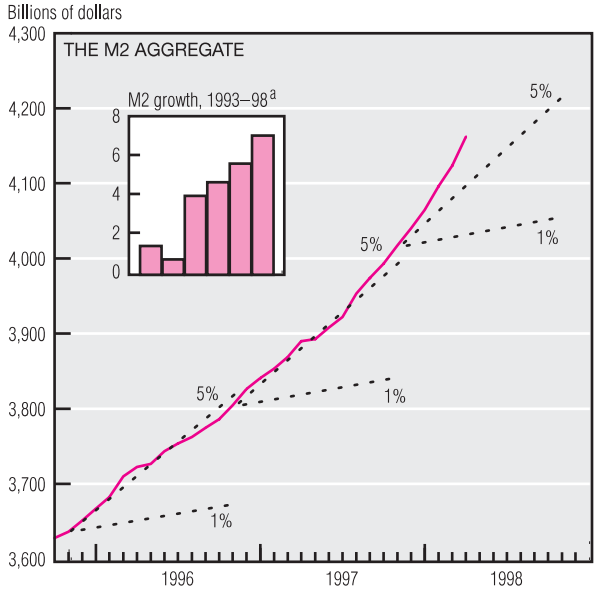
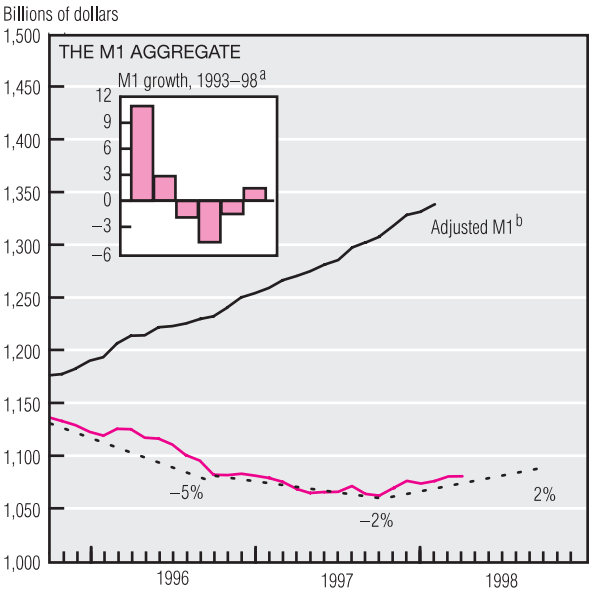
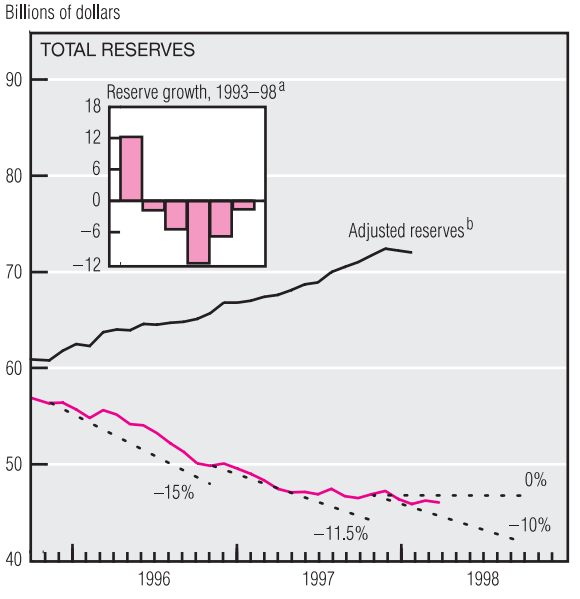
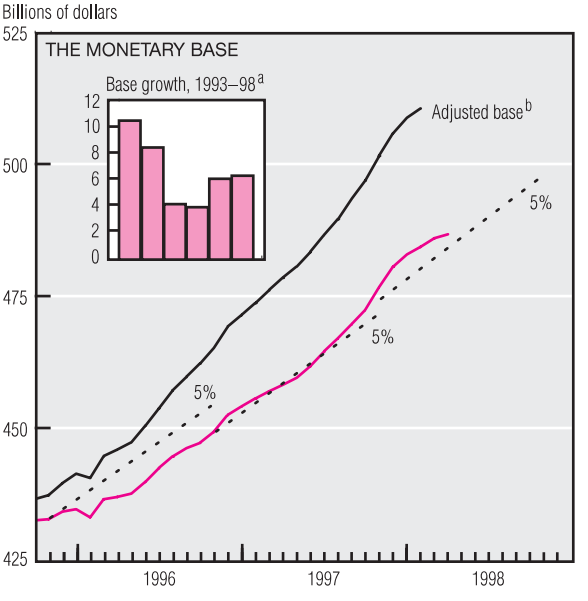
Monetary Policy









a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 1998 growth rate is a year-over-year percent change.
b. Adjusted for sweep accounts.
NOTE: All data are seasonally adjusted. Last plot is estimated for April 1998. For M2, dotted lines are FOMC-determined provisional ranges. For M1, the monetary base, and total reserves, dotted lines represent growth rates and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

Growth in the monetary aggregates was mixed last month, with the narrow measures of money slowing and the broadest aggregate, M2, expanding at a brisk 11.8% annual rate. The rapid growth in M2 followed an 8.3% increase in March and was markedly above the 7% rise posted over the last 12 months. Both numbers are well outside the Federal Open Market Committee's (FOMC) 5% provisional range, a fact that has many analysts worried that higher inflation may be just around the corner. Others are more sanguine, however, noting that the bulk of the M2 surge reflects continued vigorous growth in real GDP, not an "easy money" stance on the part of the Fed.

M1, a narrower definition of money, includes currency and checkable deposits. Unlike M2, its growth rate slowed last month to a meager 0.2%—down dramatically from 4.9% in March and also below the 1.1% pace recorded over the past 12 months. The slowdown can be traced primarily to two factors: a drop-off in the rate of home refinancing and the distorting effects of sweep accounts. Over the past year, sweep-adjusted M1 growth has run nearly 6.9 percentage points above the nonadjusted measure. Total reserves also fell in April, contracting 4.8% and partly reversing March's 10% rise. Because reserves are held only on checkable deposits, these changes largely reflect the same factors that are driving M1 growth.

The monetary base, which includes currency and reserves, inched up at an annual rate of 1.9%

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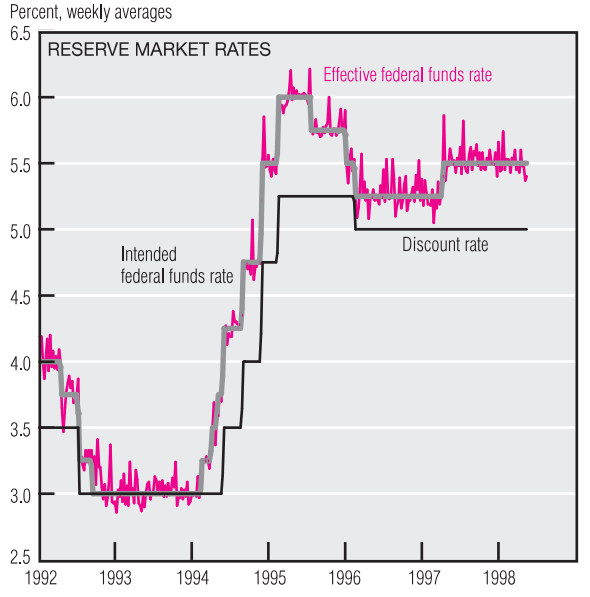
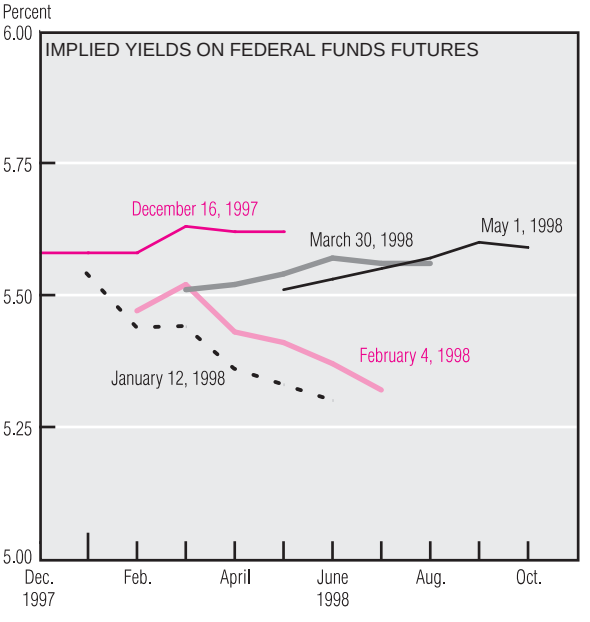
Monetary Policy (cont.)





a. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

in April, down from 4.1% in March and 6.2% over the past 12 months. Because the monetary base consists of Federal Reserve liabilities, many economists believe that it is the best indicator of the thrust of monetary policy.

Rather than controlling the monetary base directly, the Fed increases or decreases the supply of reserves to ensure that the federal funds rate hits its target. Although the current 5.5% target has not been altered for more than a year, the thrust of monetary policy can change with the underlying pressures on short-term interest rates. For example, if real interest rates declined, putting downward pressure on the 3-month Treasury bill, fewer reserves would be needed to keep the funds rate constant. A constant federal funds rate target would then imply a tightening in monetary base growth.

The 3-month Treasury now stands at 5.0%, down 9 basis points from last month and 25 basis points from a year ago. Although this falloff is consistent with the theory that monetary policy has tightened slightly, the change is rather small and probably means that policy is fairly constant.

The federal funds futures market indicates that most market participants now believe the Federal Reserve will maintain the 5.5% funds rate target over the next six months. Two months ago, however, the market was betting that the next move would be a lowering of the funds rate.

In contrast to short-term interest

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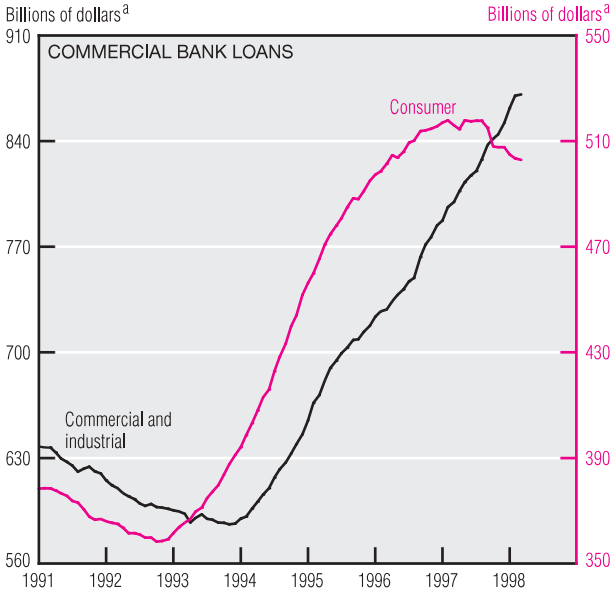
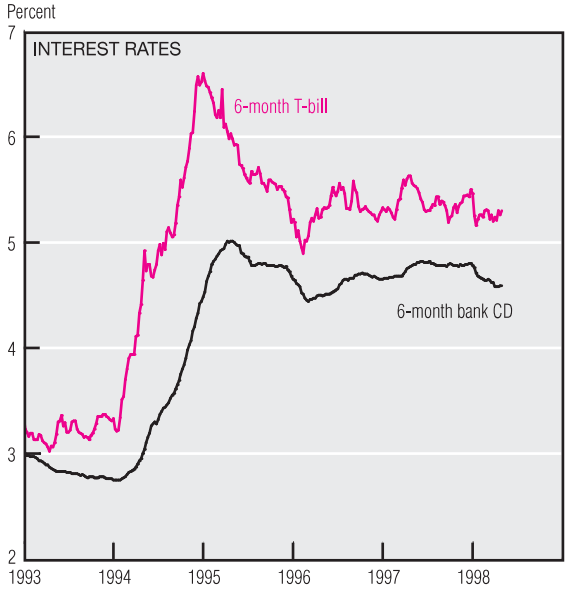
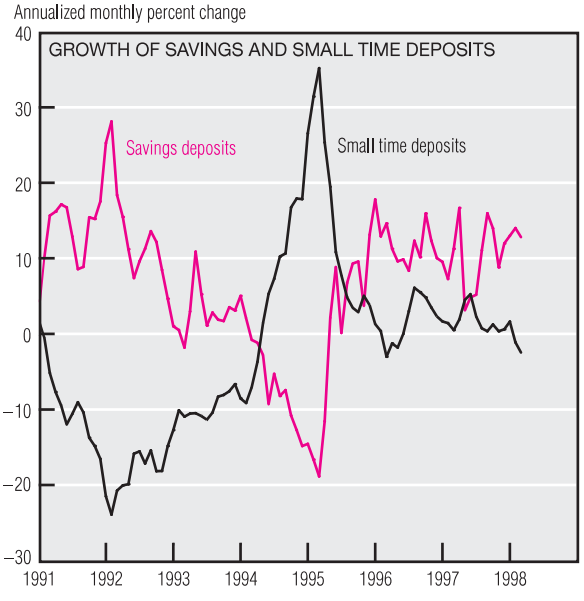
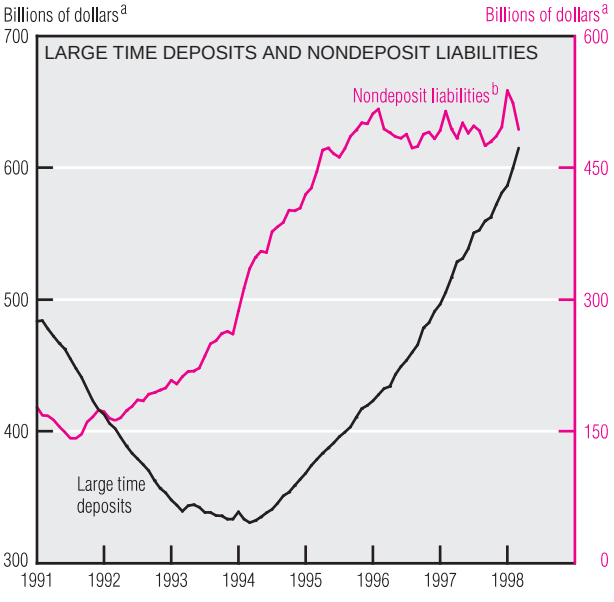
Monetary Policy (cont.)









a. Seasonally adjusted.
b. Nondeposit liabilities at commercial banks are total liabilities minus deposits and borrowings from banks in the U.S.
SOURCES: Board of Governors of the Federal Reserve System; and *Bank Rate Monitor*, various issues.

rates, longer-term rates have inched up slightly over the past month. The 30-year Treasury bond now stands at 6.0%, up 13 basis points from March's level. That rise, however, is swamped by the 100-basis-point decline experienced during the past year. The downward drift reflects the market's belief that the Federal Reserve will not allow inflation to increase much over the long term.

Home mortgage rates remain at historically low levels, although they have crept up since the beginning of the year. The current 30-year fixed rate is 7.2%, about 0.25% higher than January's average.

The number of consumer loans extended fell 1.4% in March, continuing a yearlong descent. The reasons for this downturn are unclear. Some believe that instead of reflecting a fundamental softening in demand, the decline may be due to the cash that many lenders provide to homeowners who refinance their mortgages for amounts greater than their previous loans. Commercial and industrial lending also stalled in March, increasing a slight 1.2% — well below the 12.0% pace recorded over the last 12 months. Although a one-month respite is certainly no cause for alarm, it does stand out as one of the few slowdowns since the series' frenzied increase began in 1994.

The spread between market rates and bank CD rates has remained nearly constant since mid-1996, a pattern mirrored by stabilization in the growth of small time deposits and savings deposits. To finance customers' credit demand, banks are increasingly relying on large time deposits rather than on their nondeposit liabilities.