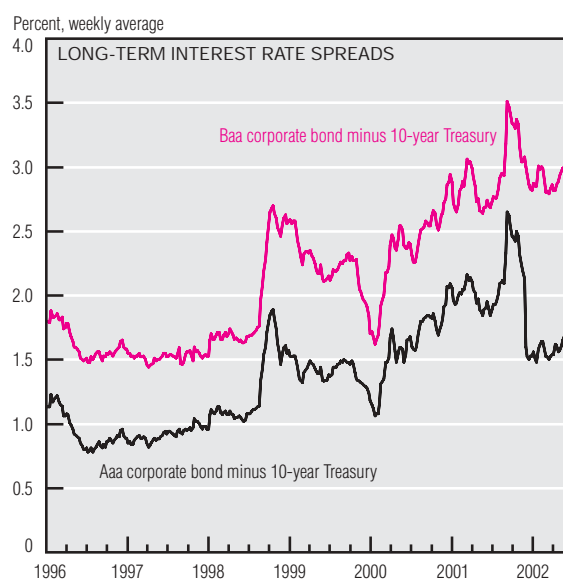
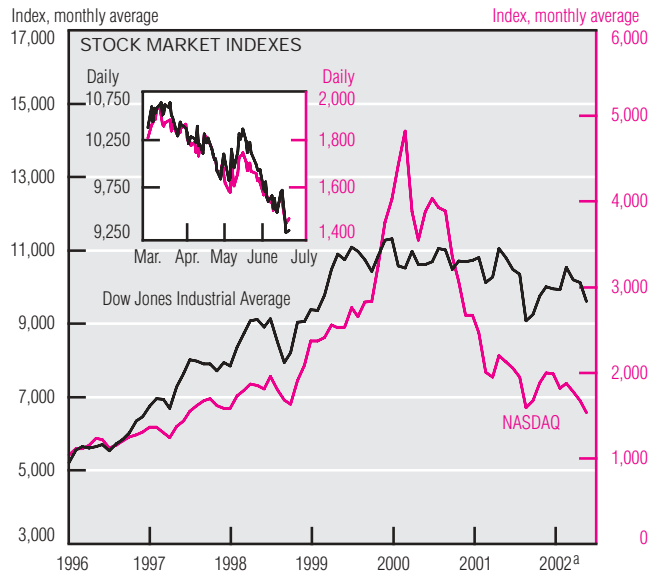
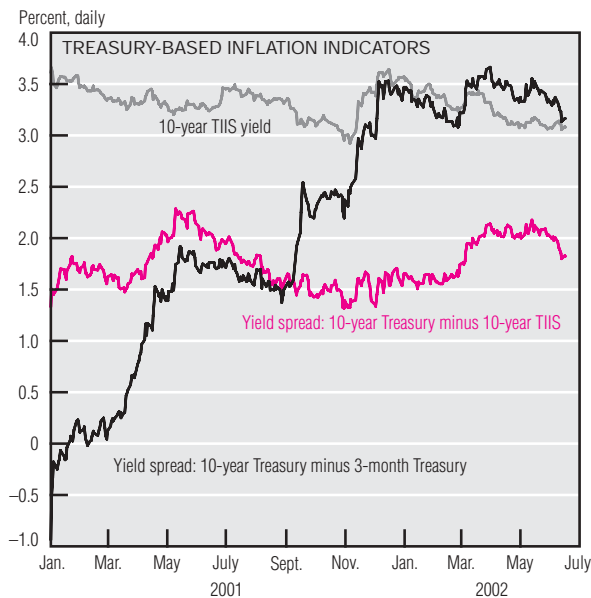


# Money and Financial Markets



NOTE: All non-inflation indexed Treasuries shown are constant maturity.

a. Monthly average for June is through June 24.

b. 3-month rate on eurodollar deposits minus 3-month Treasury bill yield.

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

In June, long-term Treasury rates dropped markedly, more than 20 basis points in the case of the 10-year Treasury. This drop could reflect moderating inflation expectations: Both the 10-year to 3-month Treasury spread and the spread between the 10-year Treasury and the 10-year Treasury inflation-indexed security have dropped recently. The stock market's poor performance may be another part of the story. As investors shift from stocks to bonds, bond prices rise and yields fall. The announcement of a delay in the 2-year Treasury note auction (formerly scheduled for

June 26) seems to have driven yields down on the short end as well. As a result of greater concern over corporate governance and geopolitical tensions, major stock market indexes are now hovering near the levels reached just after September 11.

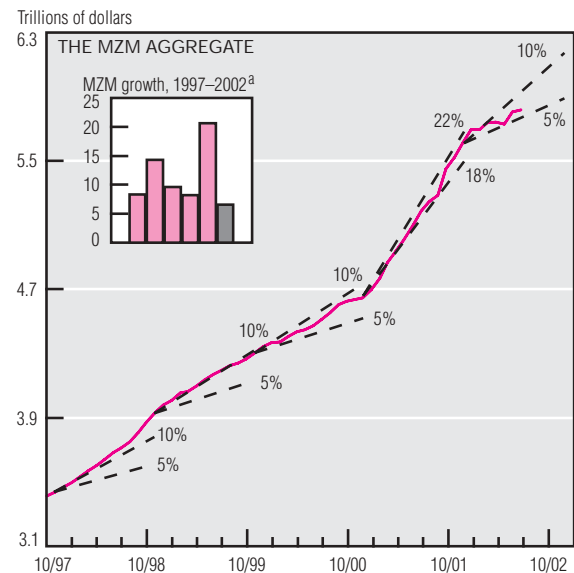
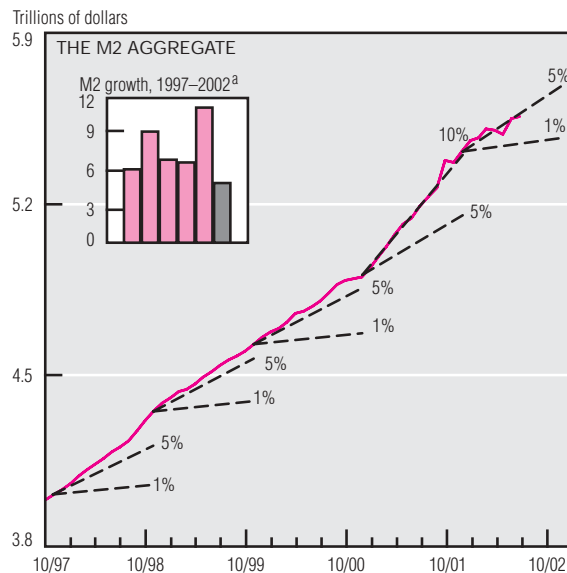
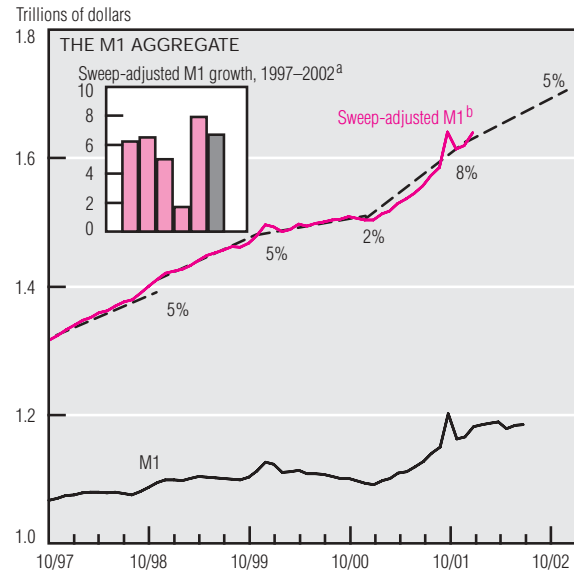
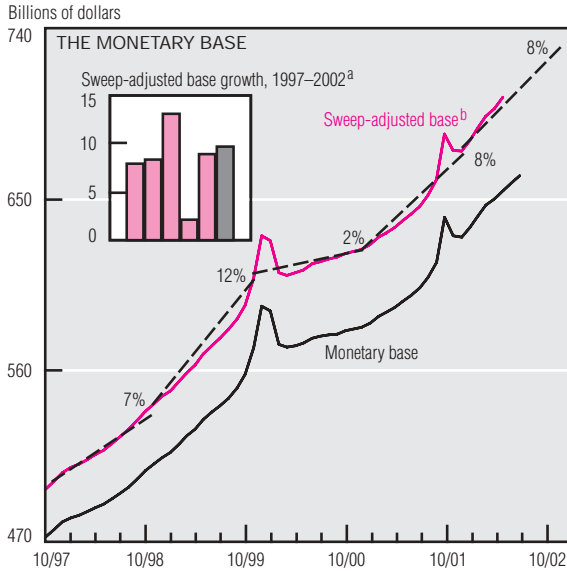
Corporate debt market indicators also seem to reflect heightened economic uncertainty. Although the spread between nonfinancial commercial paper and Treasuries has been fairly stable for the past several months, total outstanding commercial paper continues to drop and has been roughly halved since the beginning of

2001. Corporate debt restructuring, reduced business spending, and investor wariness all have contributed to this decline. The low Treasury-to-eurodollar (TED) spread is indicative of stable international financial markets, but recently it has been trending up slightly.

Spreads between corporate bonds and Treasuries have been inching up in recent weeks as well. Some of this increase may be attributed to recent disappointing earnings announcements combined with concerns over future earnings.

*(continued on next page)*

## Money and Financial Markets (cont.)



NOTE: All data are seasonally adjusted.

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

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.

SOURCE: Board of Governors of the Federal Reserve System.

The monetary base (total currency in circulation plus total reserves plus vault cash of depository institutions not applied to reserve requirements) grew fairly steadily in the first half of 2002. During that period, M1 growth slowed to a 2.2% annualized rate, primarily because a \$28.2 billion decline in demand deposits through June nearly offset a \$29.4 billion increase in currency. M2 growth through June was also lower than in some recent months. Although savings deposits—nearly half of M2—have grown briskly so far in 2002 (at an annual

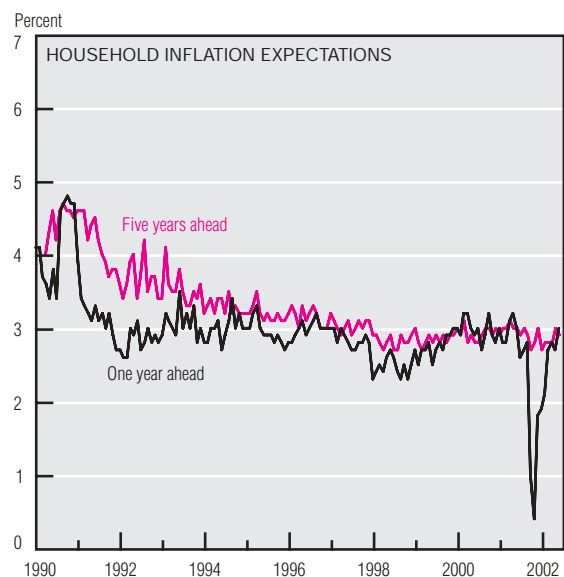
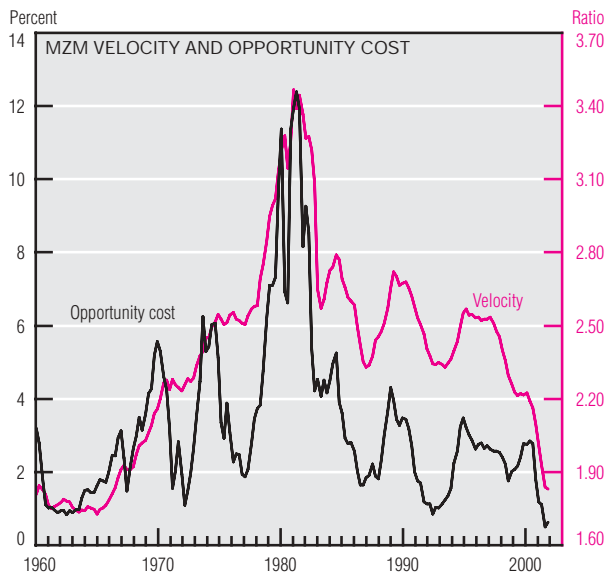
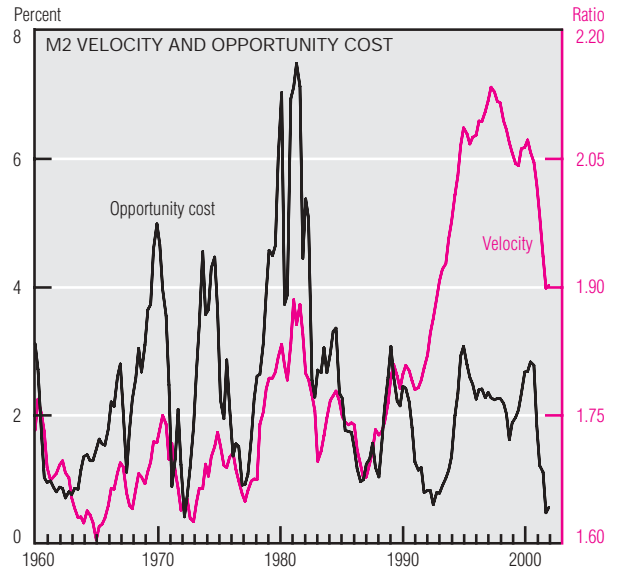
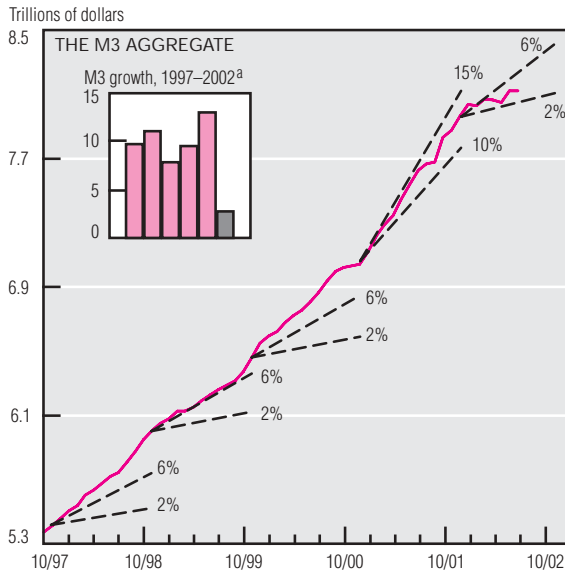
rate of about 17%), small time deposits and retail money market mutual funds declined about 9% annually, offsetting roughly half of savings deposits' growth. MZM growth, which surged in 2001 as large investors moved funds from stocks to institutional money funds (IMMFs), has been fairly stable so far this year. Likewise, M3, which also includes IMMFs, has reverted to lower growth in 2002.

Since the 1980s, financial deregulation, innovations in the mutual funds industry, and the introduction of

sweep accounts have destabilized the velocity of M1 and M2. These changes weakened those aggregates' link with nominal GDP, and in 1993 the Federal Open Market Committee stopped using the aggregates as intermediate targets for monetary policy. Since 1993, researchers have looked for other monetary aggregates that could be used as an intermediate target, MZM among them. MZM (defined to capture as closely as possible monetary instruments with zero maturity) includes both IMMFs and savings deposits, whereas M2

(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.

b. Median expected change in consumer prices.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and University of Michigan.

includes time deposits but not IMMFS. In the early 1990s, the widespread substitution of bond market mutual funds reduced demand for M2 but not for MZM. However, demand for MZM is particularly sensitive to changes in the aggregate's opportunity cost (the effective rate on the 3-month Treasury bill minus the share-weighted average of the MZM components' rates of return). As short-term Treasury yields fell in 2001, so did the velocity of MZM and M2 when they became less costly to hold. Because changes in short-term

interest rates are difficult to predict, MZM growth rates are especially unpredictable. This is evident in MZM's dramatic rise when short-term interest rates plunged in 2001. Because its growth is so difficult to forecast, MZM may not be suitable as an intermediate target.

If market rates begin rising late this year or early next and monetary policy continues its current accommodative stance, money growth will probably accelerate and, if excessive, could increase inflationary pressures. Although the moderate pace of recent

M2 and MZM growth despite low nominal interest rates suggests minimal inflationary pressures, the previously noted structural changes of the past few years have rendered monetary aggregates less useful in gauging such pressures. However, indirect measures also suggest that inflation pressures will remain subdued over the short and medium term. The University of Michigan's Survey of Consumers, for example, currently reports median one- and five-year inflation expectations of about 3%.