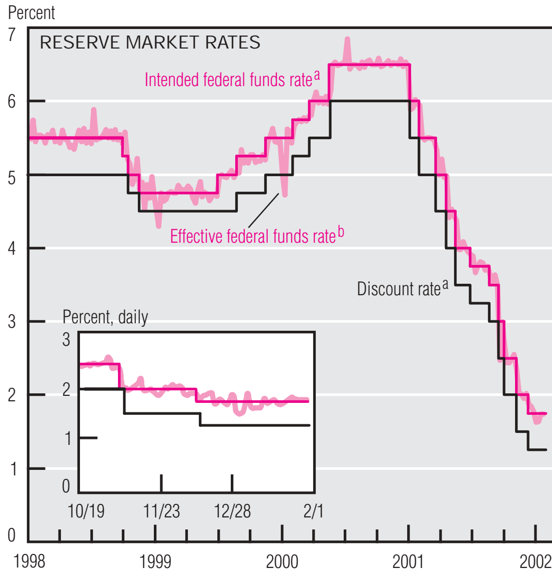
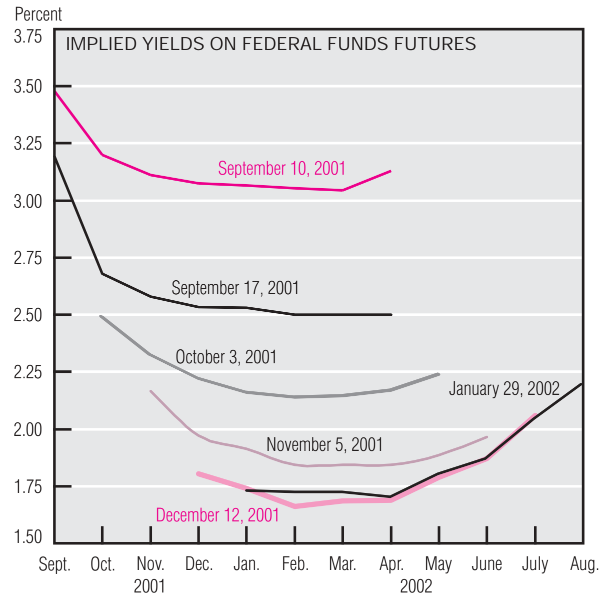
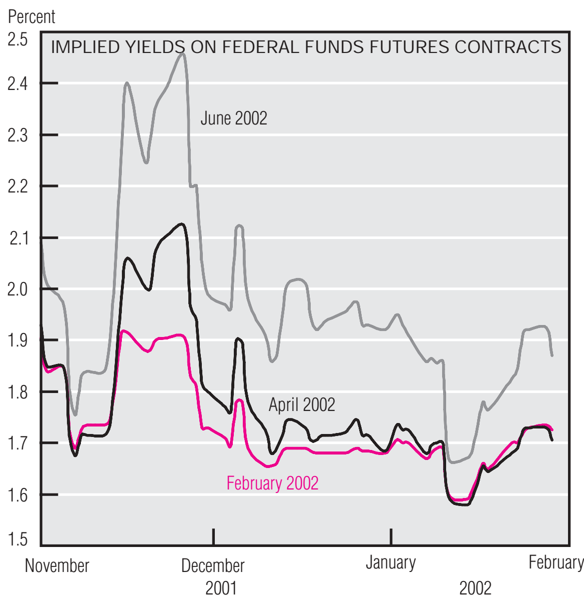
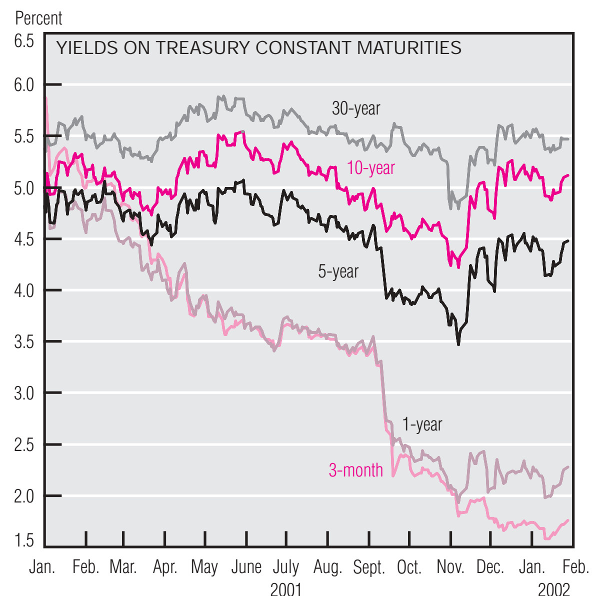
Monetary Policy









a. Daily.
b. Weekly average of daily figures.
SOURCES: Board of Governors of the Federal Reserve System; Chicago Board of Trade; and Bloomberg Financial Information Services.

At its meeting of January 29–30, the Federal Open Market Committee left the intended federal funds rate unchanged at 1.75%, while the discount rate remained at 1.25%. However, the FOMC continues to believe that "the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future."

Since no meeting is scheduled for February, the implied yield for the federal funds futures contract for that month should be a good indicator of how market participants expected the FOMC to act at its January 29–30 meeting. Throughout much of January, a fair probability of a further rate cut was priced into the contract. Near the end of the month, yields showed that most participants expected the current easing cycle to end. Recent positive data on consumer sentiment, initial unemployment insurance claims, and the index of leading indicators in particular were likely incorporated in the upward revision of the expected funds rate. During January, short-term Treasury rates moved closely with market expectations of the fed funds rate.

Longer-term rates dropped in the first half of January and rose in the second. Since September, the spread between the 10-year and 3-month Treasuries has increased markedly. This spread is frequently used as an indicator of either higher future inflation or higher future real rates. However, the trends of more inflation indicators, such as the spread between the 10-year Treasury and 10-year inflation-indexed securities (TIIS), suggest that inflation expectations have not changed

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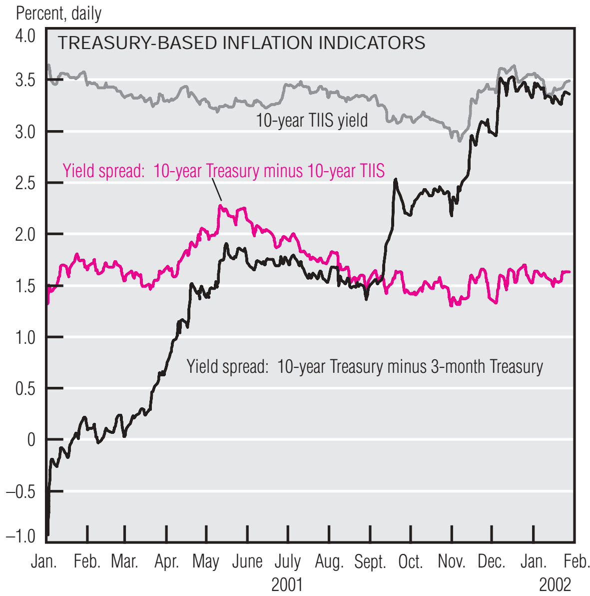
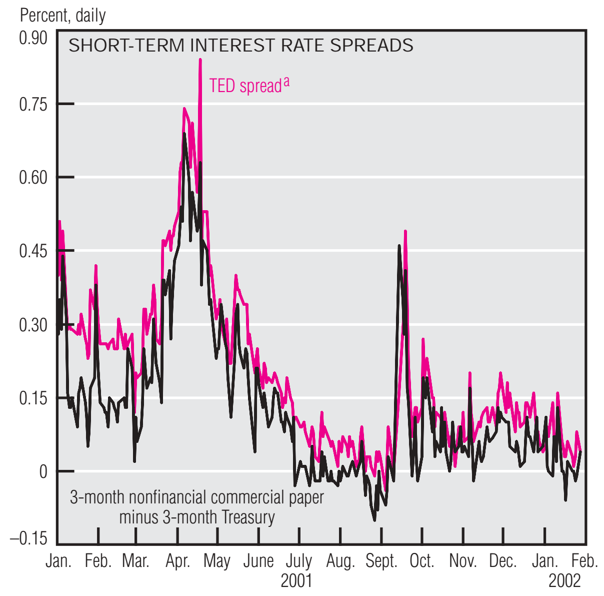
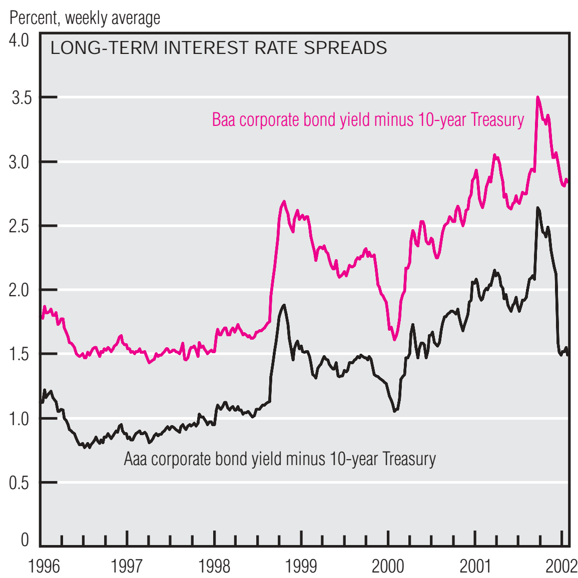
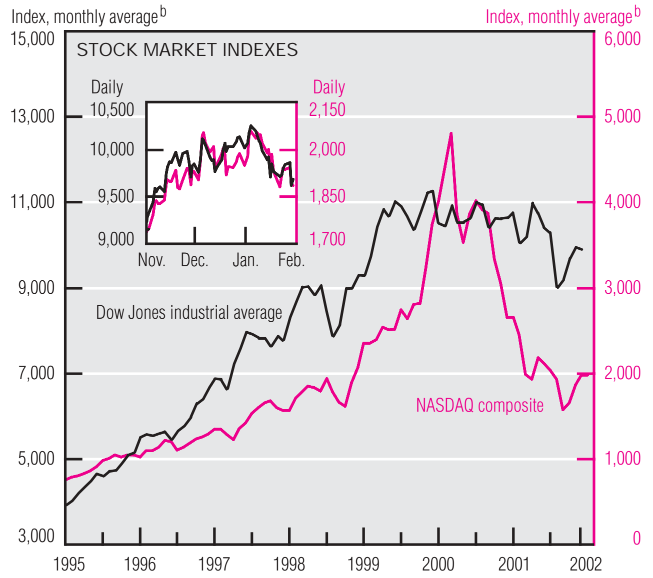
Monetary Policy (cont.)









NOTE: All Treasuries referred to are constant maturity.
a. 3-month euro minus 3-month constant maturity Treasury bill yield.
b. Through January 29, 2002.
SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg Financial Information Services.

appreciably. The TIIS rate has been flat since September.

Concern over budget deficits is often cited as one factor that can keep long-term interest rates high. Despite the likely need for future deficit spending to fight terrorism, this explanation for the increased spread between the 10-year and 3-month Treasuries does not seem valid either. Rather, the September 11 terrorist attacks had little impact on long-term rates but dramatically reduced short-term rates. Thus, the increase in the spread most likely reflected a sharp but temporary drop in short-term rates. This decrease was subsequently supported by a cumulative reduction of 1.75 percentage points in the federal funds rate that market participants consider likely to be taken back over the next couple of years.

Recessions are often associated with a sharp rise in the spread between the cost of private borrowing and Treasury borrowing. No such increase has occurred during the current downturn, as indicated by the low spread between commercial paper and the 3-month Treasury. International financial stability has also contributed to the low Treasury-to-euro (TED) spread.

Other gauges of the spread between private and public borrowing are the spreads between corporate bonds and 10-year Treasuries. Both the Aaa and Baa corporate bond rate spreads dropped appreciably over the last months of 2001 and have been essentially flat since January. The same pattern can be seen in equity prices, which rose for several months but have remained flat or declined slightly since January.