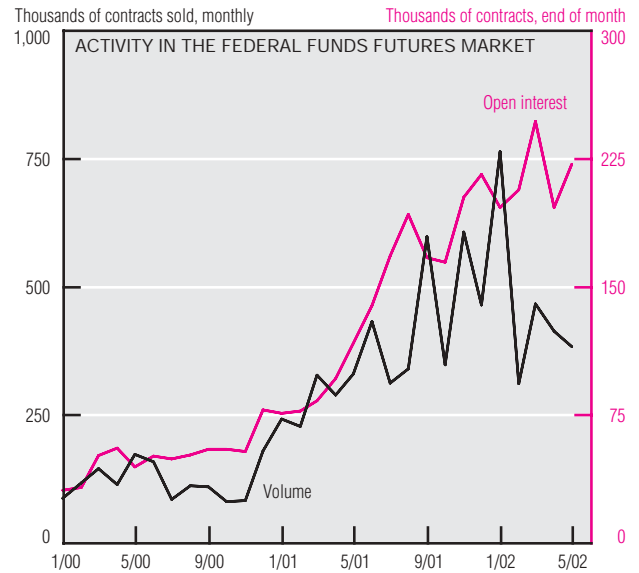
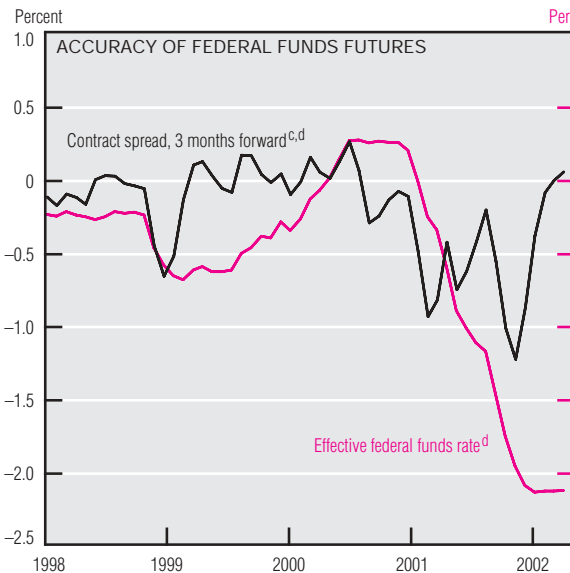
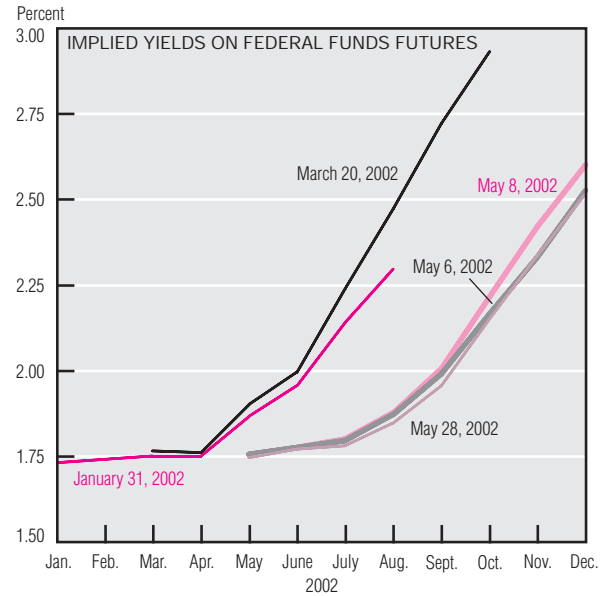
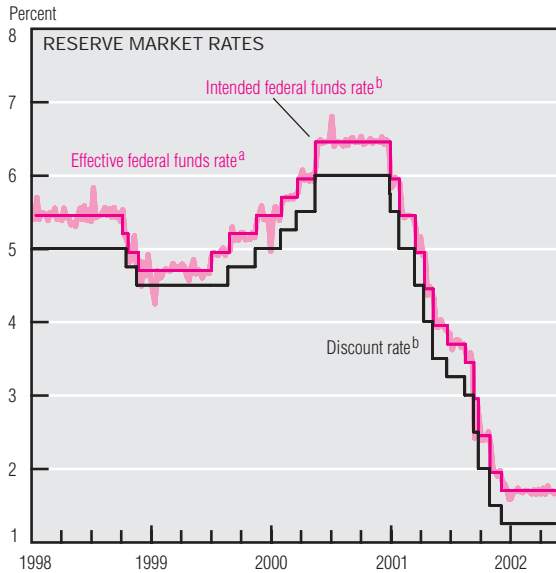


Monetary Policy



a. Weekly average of daily figures.

b. Daily.

c. The spread is defined as the monthly average of the effective federal funds rate for the month in which the fed funds futures contract delivers minus the implied yield on the futures contract.

d. Monthly average of daily figures.

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

At its May 7 meeting, the Federal Open Market Committee left the intended federal funds rate unchanged at 1.75%. Its press release stated that "economic activity has been receiving considerable upward impetus from a marked swing in inventory investment," but the strength of final demand over the next few quarters is uncertain.

Implied yields on fed funds futures scarcely moved in response to the May 7 press release and have moved little since then. Current yields indicate that market participants place a high probability on an increase of

25 basis points (bp) in the funds rate by September.

The value of a federal funds futures contract at delivery is determined by the average effective funds rate during the month of delivery. So, apart from a premium for interest rate risk, implied fed funds futures yields should reflect expectations of the effective rate for the delivery month. However, implied futures yields appear to overestimate the fed funds rate when rates fall quickly and underestimate it when rates rise quickly. In 2001, when the intended rate fell 475 bp, 3-month fed funds futures

overestimated the effective rate by 68 bp on average.

Although fed funds futures market participants have difficulty predicting rates during episodes of large rate changes, this does not appear to have constrained market activity in 2001. The number of open (outstanding) contracts rose dramatically in 2001, while the number sold more than tripled—from 1.4 million in 2000 to 4.5 million in 2001. In 2002, however, the number of contracts sold has dropped markedly. Without changes in the fed funds rate, participants may have less need to hedge against risk.