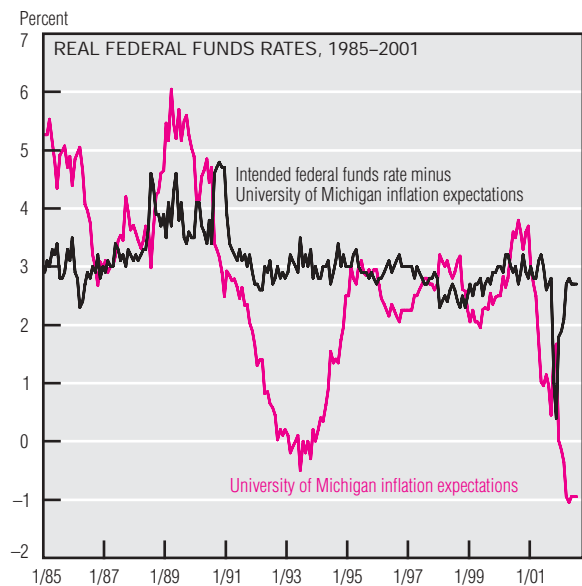
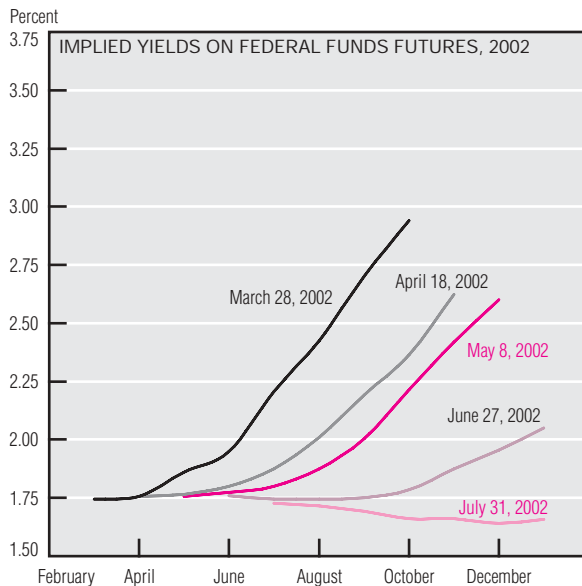
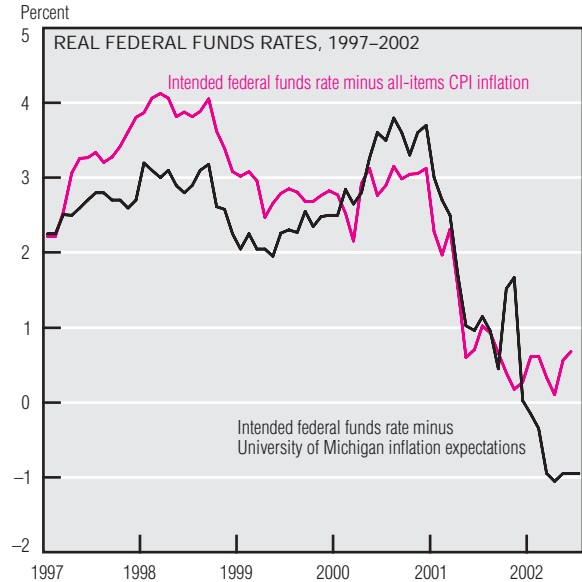
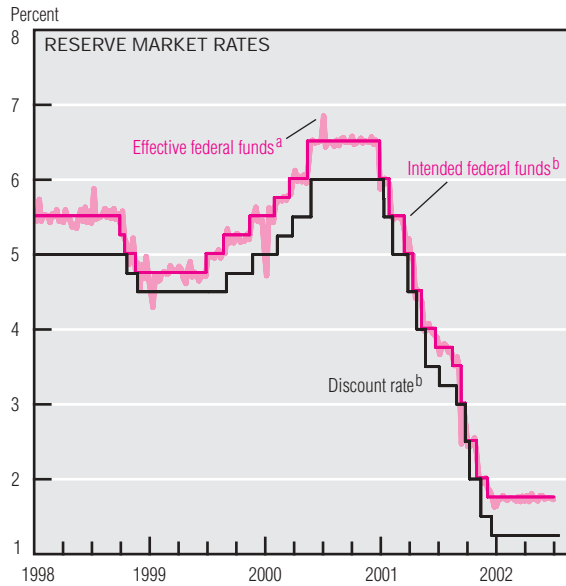


Monetary Policy



a. Weekly average of daily figures.

b. Daily.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15; University of Michigan, *Survey of Consumers*; and Bloomberg Financial Information Services.

At its June 26 meeting, the Federal Open Market Committee (FOMC) decided to leave the federal funds rate unchanged at 1¾%, its intended level since December 2001. Noting that incoming information confirmed a continuing increase in economic activity, the Committee deemed the current policy stance accommodative. In light of current information, the Committee perceives that the risks are balanced with respect to the prospects for its two goals—price stability and sustainable growth.

The inflation-adjusted fed funds rate has been near zero in backward-

looking terms and negative in forward-looking terms, an unsustainably low rate in either case. Although the unchanged funds rate objective came as no surprise to financial markets, earlier this year the fed funds futures market showed that market participants were expecting rate increases to begin in the spring.

As information confirmed stronger-than-expected economic activity in the first quarter, fed funds futures were priced in anticipation of rates' imminent upward trajectory. Subsequent revelations, however, which raised concerns about the quality of corporate earnings, caused a sharp

decline in equity prices and put the sustainability of the economic expansion in doubt. Consequently, the expected arrival of rate increases has been pushed out for several months. In fact, by the end of July, the market had priced in the possibility of another rate cut.

But how long can a funds rate be maintained near zero before inflation accelerates? Experience during the early 1990s suggests that such a state can be sustained for an extended period, provided rates are raised rapidly enough when inflationary pressures emerge.