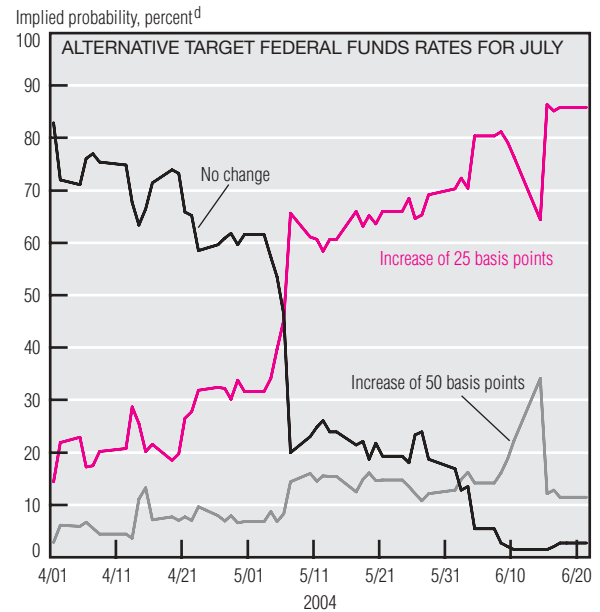
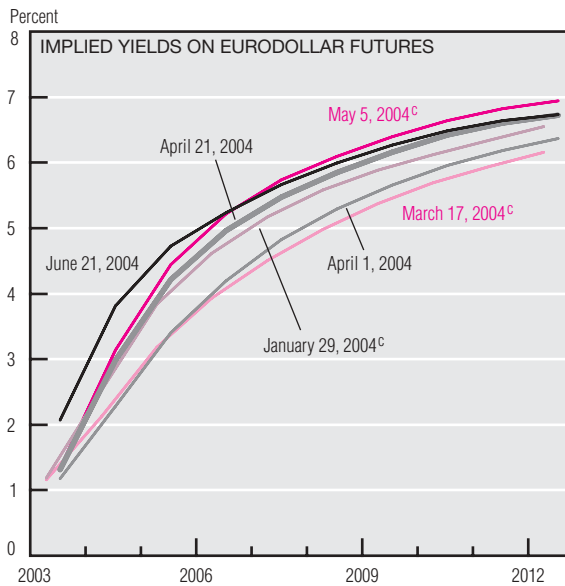
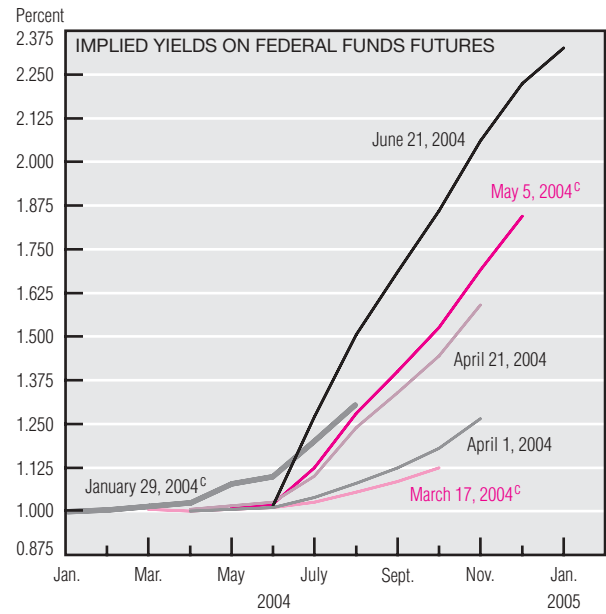
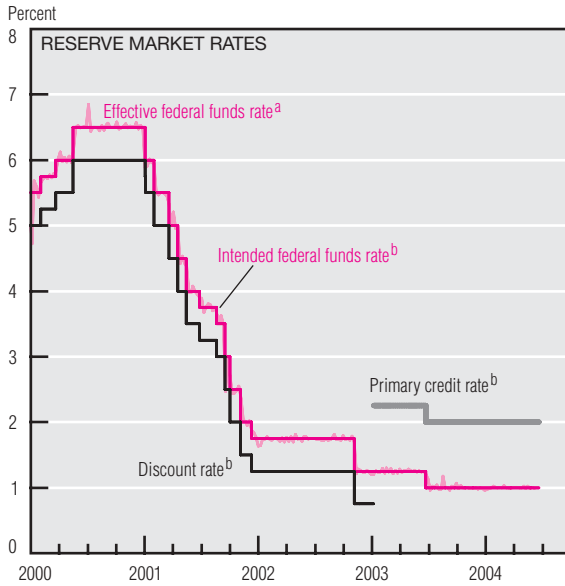


Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. One day after the FOMC meeting.

d. Probabilities are calculated by using prices from options on July 2004 federal funds futures that trade on the Chicago Board of Trade.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; and Bloomberg Financial Information Services.

The intended federal funds rate has held constant at 1% for nearly a year. Nevertheless, expectations of future monetary policy have shifted significantly over this period. Among the many ways to gauge changes in policy expectations, federal funds futures provide a short-run view. Since the May meeting of the Federal Open Market Committee (FOMC), market participants have moved forward their expectations of the next round of policy tightening and now expect it to be more aggressive than before. Eurodollar futures, which provide a longer-term picture, tell a similar story.

In early spring, the Chicago Board of Trade began to deal in fed funds options, from which one can extract the probabilities associated with funds rate changes of varying magnitudes. At its May 4 meeting, the FOMC changed its statement to indicate a pickup in inflation, noting that "policy accommodation can be removed at a pace that is likely to be measured." Three days later, the market received a stronger-than-expected employment report. After these two events, market participants placed the probability of a 25 basis point hike in June at more

than 65%, compared to about 30% a few days earlier.

FOMC members' statements have also affected market expectations. For example, St. Louis Fed president William Poole's June 12 statement that the Fed was willing to lift the funds rate "further and faster" prompted participants to shift their expectations toward a 50 bp hike. However, after Chairman Greenspan's June 15 reiteration that rate hikes would be "measured," they shifted back down. Participants are now confident that a rate hike will occur at the June 29–30 FOMC meeting.