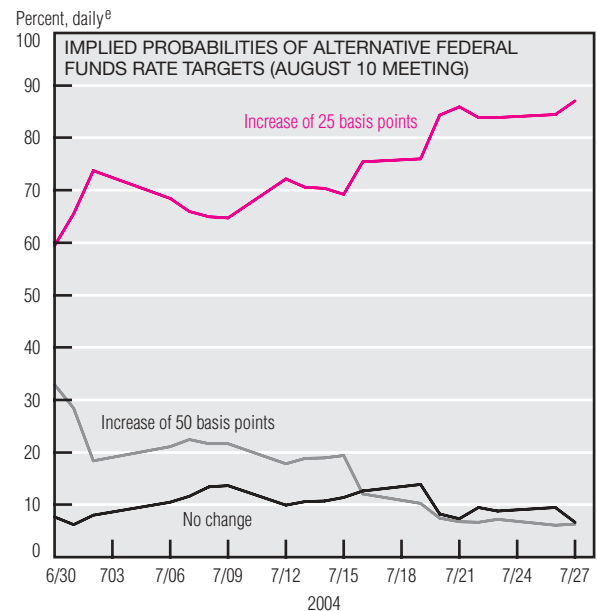
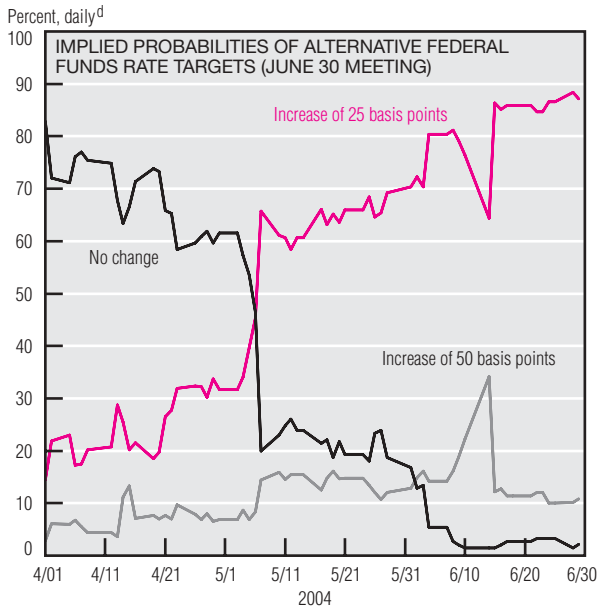
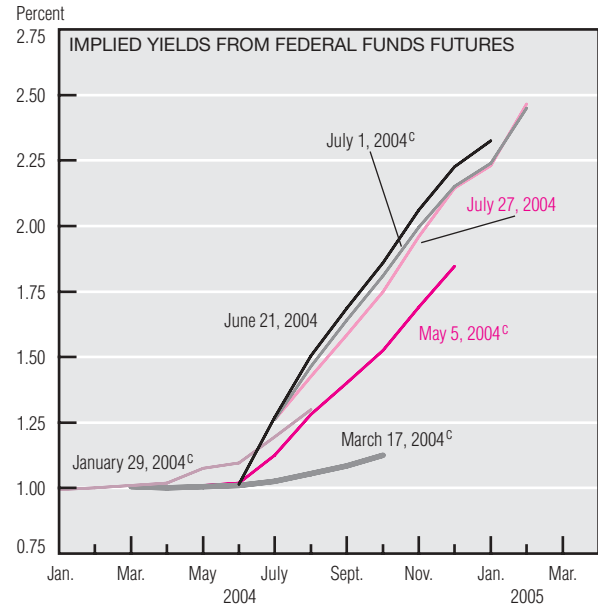
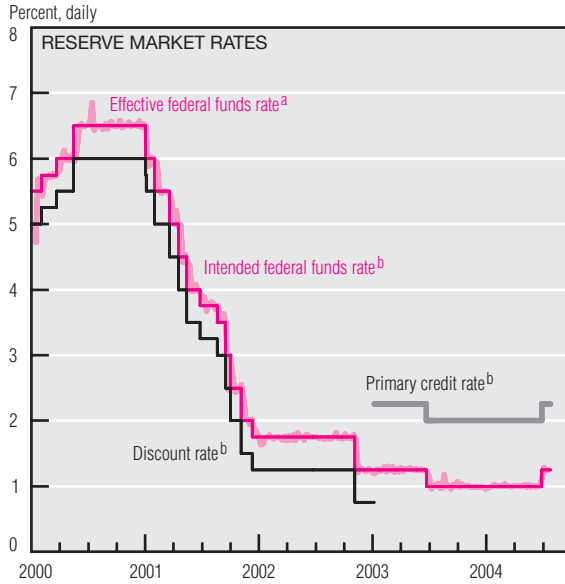


Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. One day after the FOMC meeting.

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

e. Probabilities are calculated by using trading-day closing prices from options on August 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.

On June 30, the Federal Open Market Committee raised its federal funds rate target from 1% to 1¹/₄%, initiating an anticipated series of rate hikes to return policy to a neutral stance. The previous action—a ¹/₄ point rate decrease one year ago—was followed by a deliberate, transparent policy stance designed to maintain an accommodative policy for "a considerable period." The steady 1% overnight yield exceeded virtually every measure of inflation expectations, producing a negative real return. Though such a policy was widely understood to be unsustainable, concerns about

slow employment growth and the slight probability of deflation offset concerns about a rise in inflation through mid-March.

The sharp acceleration in employment during the spring and the surprising turnaround in inflation brought the trajectory of expected rate hikes nearer in time. Implied yields on fed funds futures rose steadily until early May, when they jumped sharply in response to the month's employment growth report. Moreover, the market-implied probability that no policy action would be taken at the June meeting fell sharply, while the

probability of a 25 basis point (bp) hike jumped (as, to a lesser extent, did the estimate for a 50 bp hike).

The likelihood of no change drifted down to almost nil, where it remained after the strong June employment report. At mid-month, the market began to weight the prospect of a 50 bp hike more heavily after a series of speeches by FOMC members were interpreted as expressions of a more aggressive policy stance. This change in perception was reversed, however, after Chairman Greenspan's nomination testimony suggested a more patient approach.