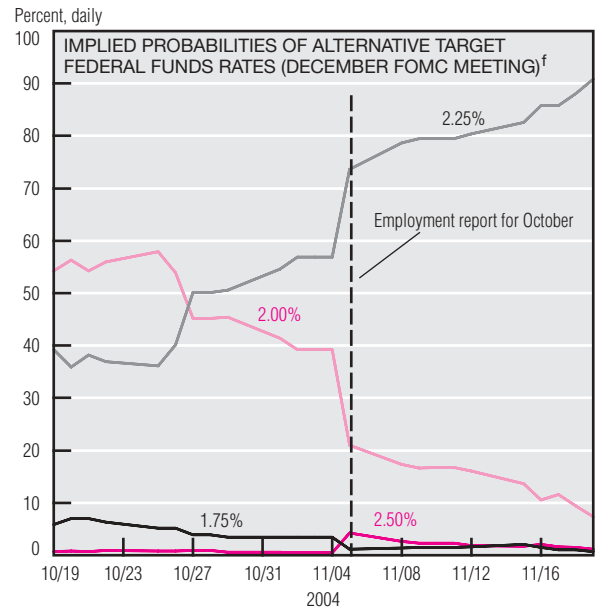
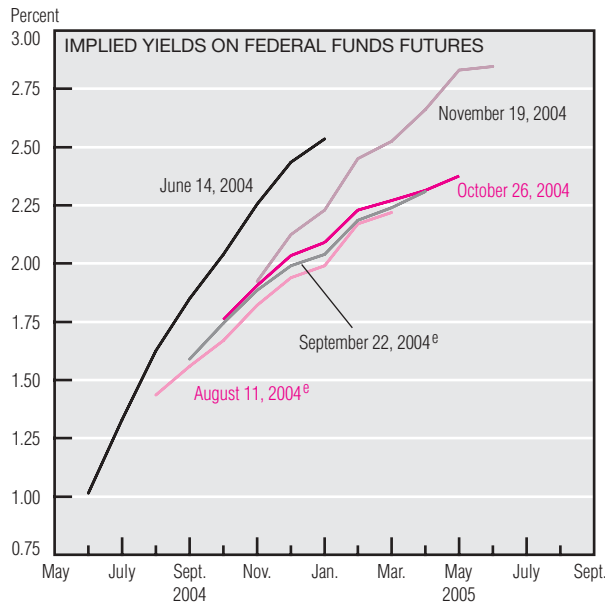
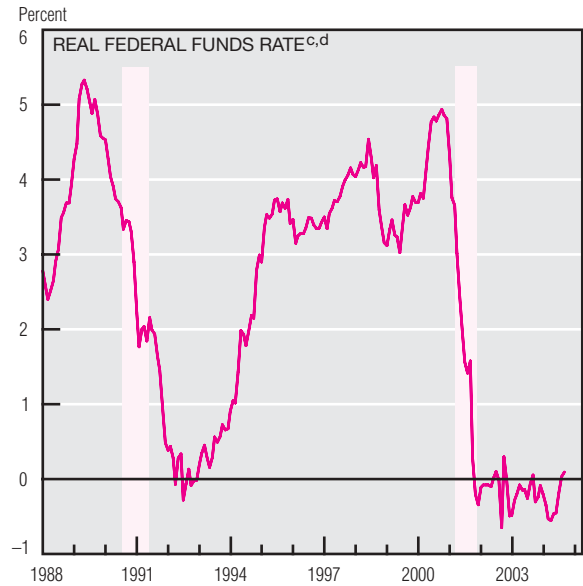
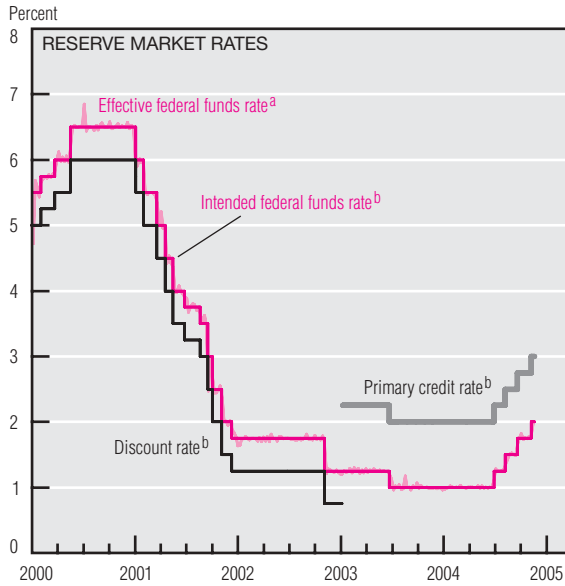


Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. Defined as the effective federal funds rate deflated by the core PCE Chain Price Index.

d. Shaded bars indicate periods of recession.

e. One day after the FOMC meeting.

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

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; 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.

At its November 10 meeting, the Federal Open Market Committee (FOMC) raised its target for the federal funds rate from 1.75% to 2%—just above the inflation rate for core personal consumption expenditures (PCE) over the past year. A quarter-point hike had been widely anticipated in financial markets.

The action was also consistent with the FOMC's recent pattern of policy announcements and actions. After its May meeting, it adopted statement language noting that

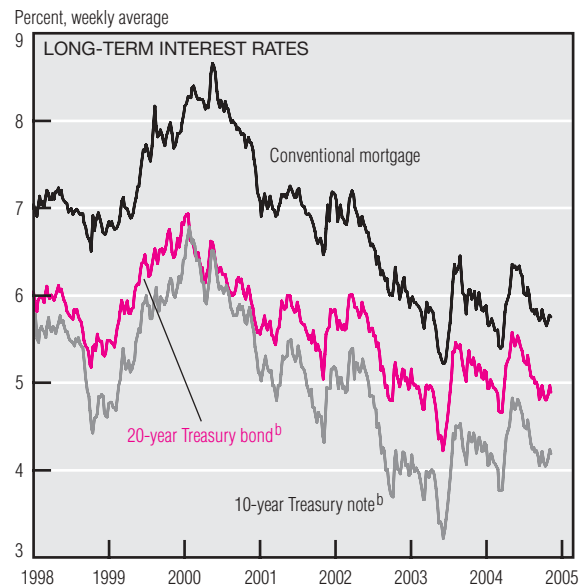
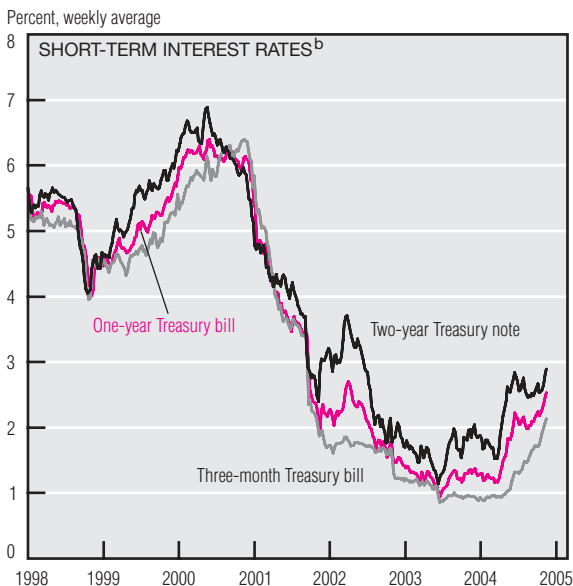
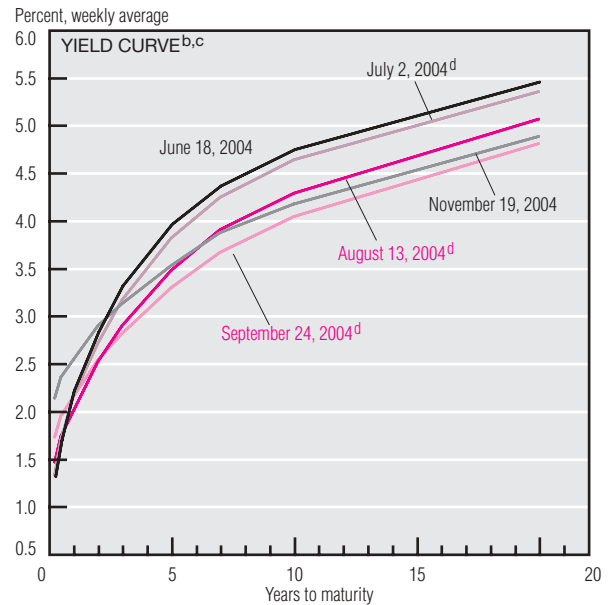
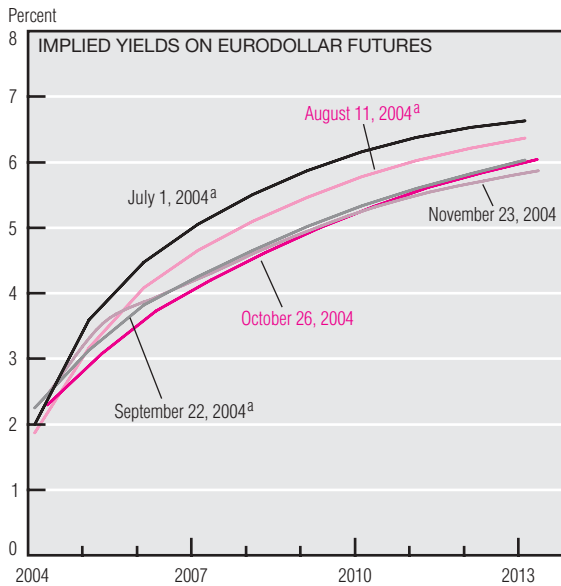
"the Committee believes that policy accommodation can be removed at a measured pace." At all four meetings since May, the FOMC has chosen to raise the fed funds rate target 25 basis points and to repeat the statement language. Futures and options prices during the weeks before each meeting placed high probabilities on the outcomes ultimately chosen. Thus, quarter-point hikes have been viewed as a measured pace of policy tightening.

Two weeks before the FOMC's November meeting, however, prices

for futures and options revealed a possible break in the recent pattern. Specifically, they implied that policymakers would maintain the measured pattern at their November meeting, but then would probably pause, leaving the target rate unchanged in December. During the summer, incoming data indicated that economic activity was weaker than expected, which suggested that policy was no longer as accommodative. Implied yields began to recede from their

(continued on next page)

Monetary Policy (cont.)



- a. One day after the FOMC meeting.
 b. All yields are from constant-maturity series.
 c. Average for the week ending on the date shown.
 d. First weekly average available after the FOMC meeting.

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

June 14 peaks. In late October, however, data suggested that a pickup might be at hand. A strong employment report on November 5 reinforced the optimistic view, making a December rate hike of 25 basis points unambiguously the most likely outcome. This action would result in a real fed funds rate more clearly in positive territory.

Implied yields derived from euro-dollar futures provide some measure of expected policy actions over longer horizons. Because these yields include premiums related to a variety

of risks exceeding those faced in the federal funds market, they tend to overpredict the fed funds rate, especially in the out years.

Nevertheless, changes over time in the slope of implied yields are largely consistent with changing policy predictions. They reveal a substantial shift in the expected fed funds rate two years and more in the future. Weak incoming data during the summer and early fall suggested not only a policy pause in the near term, but also a less restrictive monetary policy later in the expansion.

The changes in implied yields paralleled changes in the yield curve. Over the second half of 2004, short-term interest rates tended to rise as long-term rates fell. Short-term rates are more closely linked to expected changes in the fed funds rate. The real fed funds rate, which has been near or below zero, could increase and still remain accommodative. Long-term rates, on the other hand, are driven largely by underlying economic fundamentals and inflation expectations.