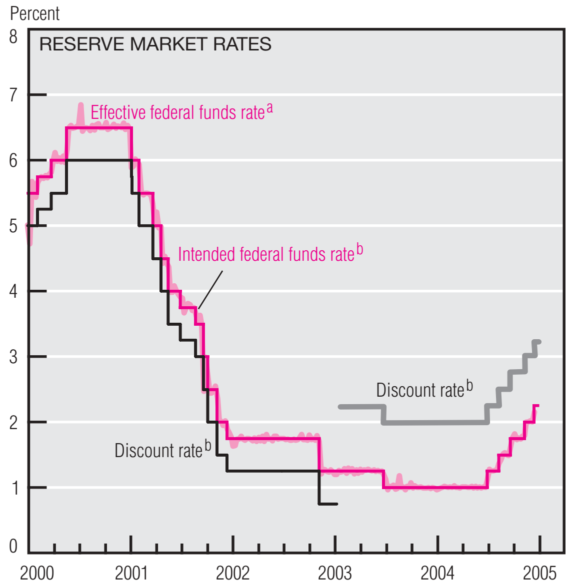
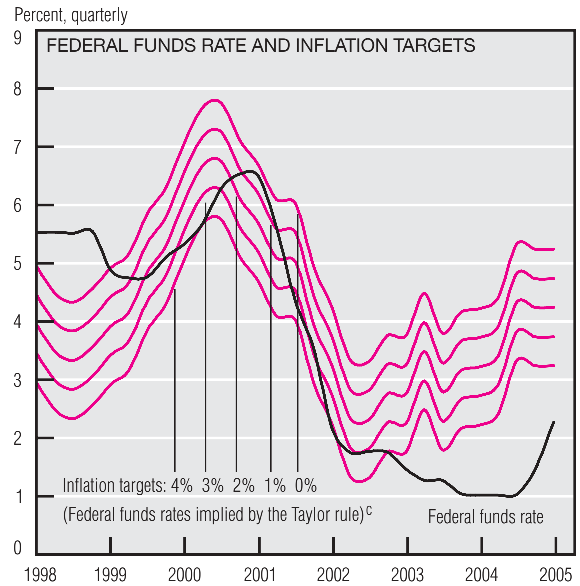
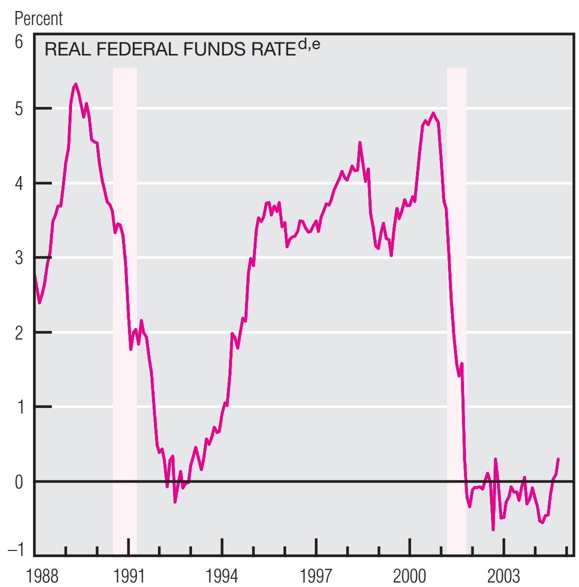
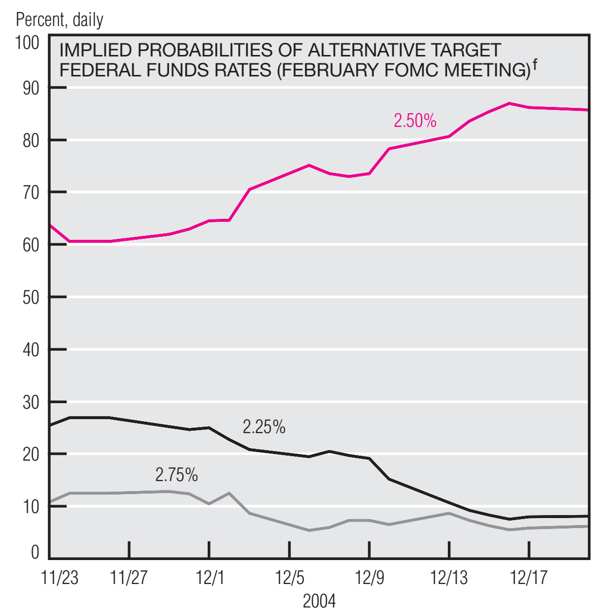
Monetary Policy









a. Weekly average of daily figures.

b. Daily observations.

c. The formula for the implied funds rate is taken from Federal Reserve Bank of St. Louis, *Monetary Trends*, January 2002, which is adapted from John B. Taylor, "Discretion versus Policy Rules in Practice," *Carnegie-Rochester Conference Series on Public Policy*, vol. 39 (1993), pp. 195–214.

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

e. Shaded bars indicate periods of recession.

f. Probabilities are calculated using trading-day closing prices from options on February 2005 federal funds futures that trade on the Chicago Board of Trade.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office; 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 December 14, the Federal Open Market Committee (FOMC) raised its target for the federal funds rate by 25 basis points (bp) to 2.25%, its fifth consecutive upward move. (Separately, the Federal Reserve's Board of Governors raised the discount rate to 3.25%.) The FOMC remarked that "even after this action, the stance of monetary policy remains accommodative," and in fact, the fed funds rate remains low by several conventional standards. One, the Taylor rule, posits that the FOMC balances its response between economic growth and inflation. The form of the Taylor rule depends on the weights given to inflation and output and the assumed inflation target. Since mid-2002, the rate has stayed below the rule's prediction, even assuming a rather high inflation target of 4%. In the past several months, however, the gap has diminished from 230 bp to 97 bp.

The real federal funds rate (the fed funds rate less current inflation) is another standard. The real rate has been mostly negative since 2001. Although it increased noticeably in 2004, going positive in August, it remains low by recent historical standards.

Does this accommodative policy presage more rate increases? Market participants seem to think so. Evidence from options on fed funds futures implies that traders see an 86% probability that the rate will be raised to 2.50% at the February 2005 meeting. The odds of no change or increasing the target by 50 bp are both less than 10%.