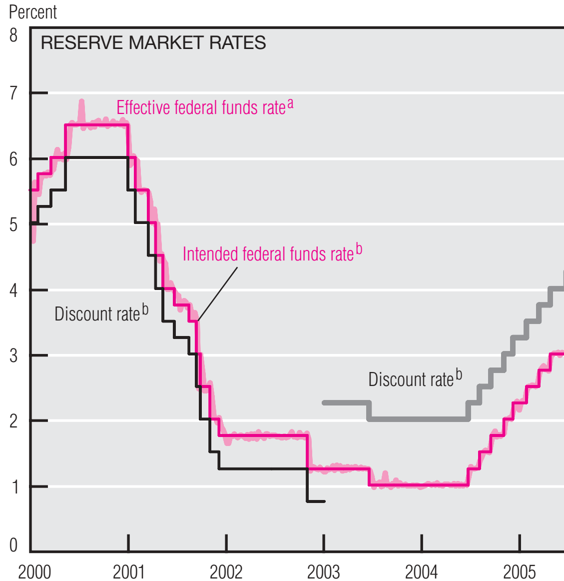
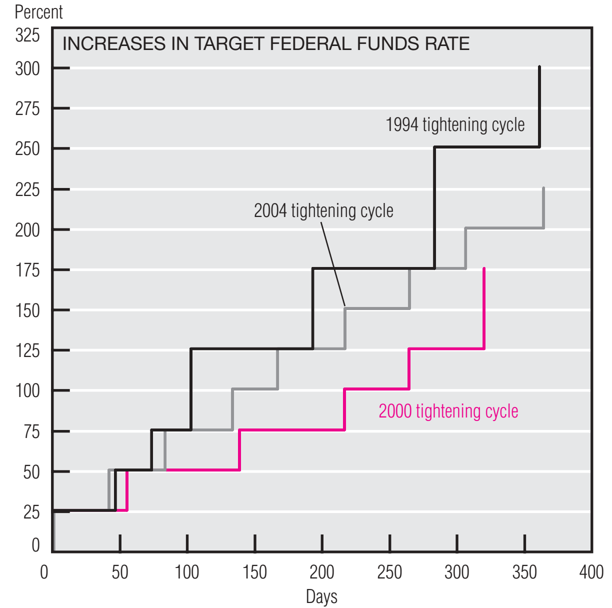
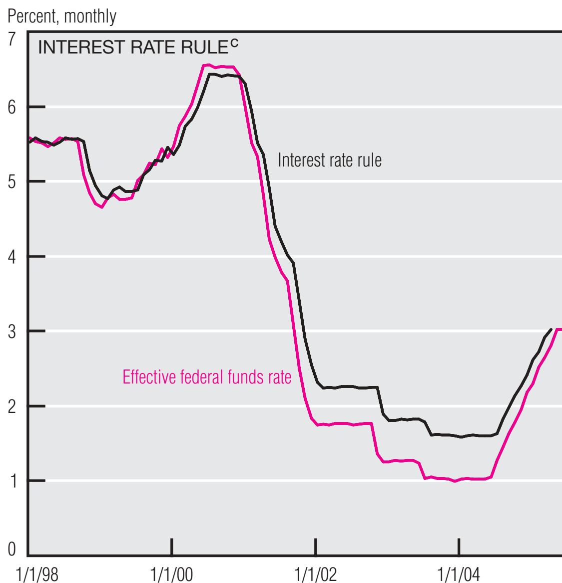
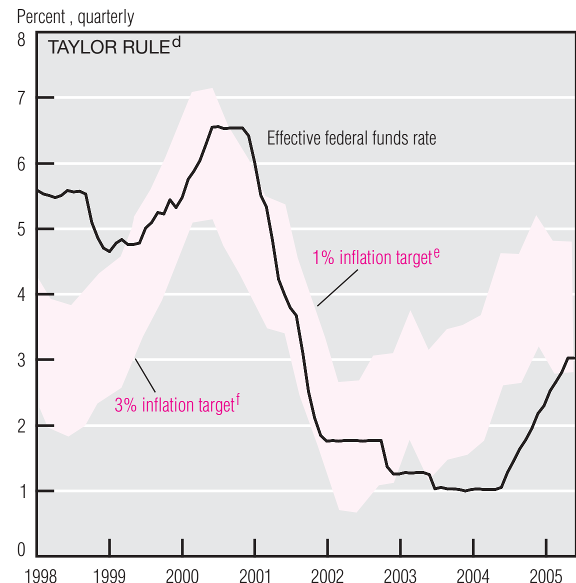
Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Interest rate rule using effective federal funds rate and two-year Treasury bill.
d. 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.
e. Assumes an interest rate of 2.5% and an inflation target of 1%.
f. Assumes an interest rate of 1.5% and an inflation target of 3%.
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.

On June 30, the Federal Open Market Committee (FOMC) announced that the target federal funds rate increased by 25 basis points to 3.25, the ninth consecutive increase. The discount rate increased to 4.25%, remaining 100 basis points above the target funds rate. With this "ninth-inning" increase and continuation of the language about a measured pace, the question on everyone's mind is, "How high will the FOMC go?"

One approach is to look at the FOMC's past behavior. "Tightening cycle" is a bit of a misnomer (because tightening should be judged relative to market rates, not in an absolute fashion), but comparing recent increases to the past provides a useful perspective. Increases since 2004 have proceeded slightly faster and gone further than in the 2000 cycle, but still lag behind the 1994 increases on both counts.

Concentrating on rates alone strips the problem of its economic context, which may be at least partially restored by viewing the federal funds rate as a "rule" or reaction to the broader economy. One such rule regards movements in the funds rate as responses to changes in market interest rates, specifically the two-year Treasury yield. This puts current rates right in line with what is predicted. The most famous rule, named for

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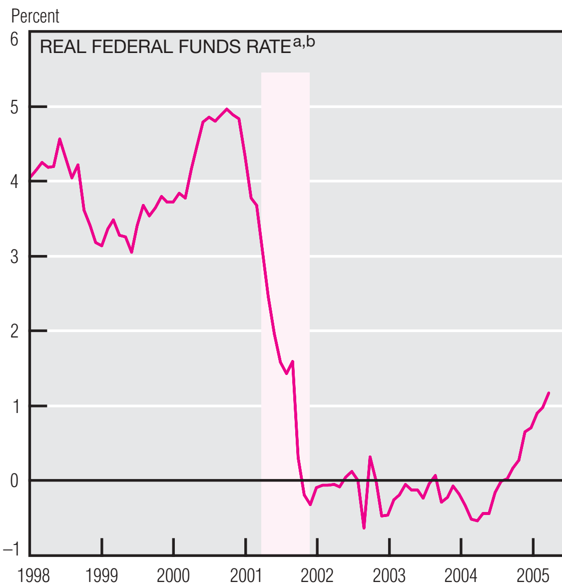
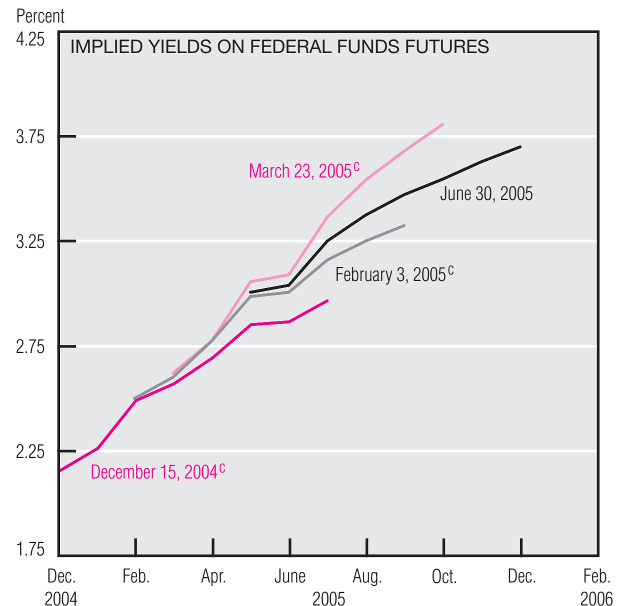
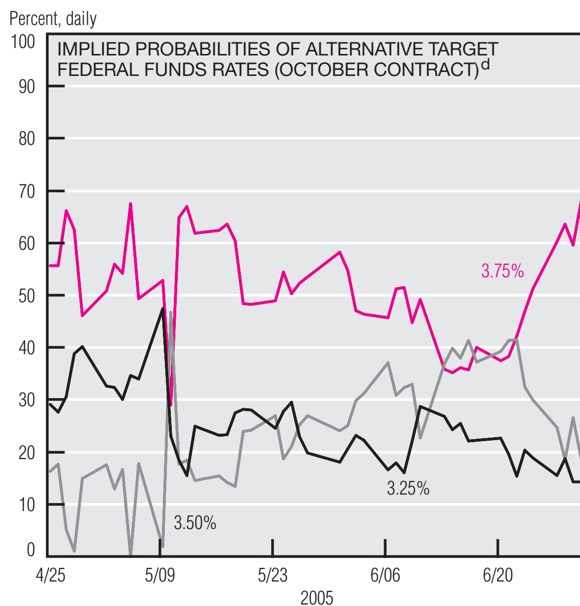
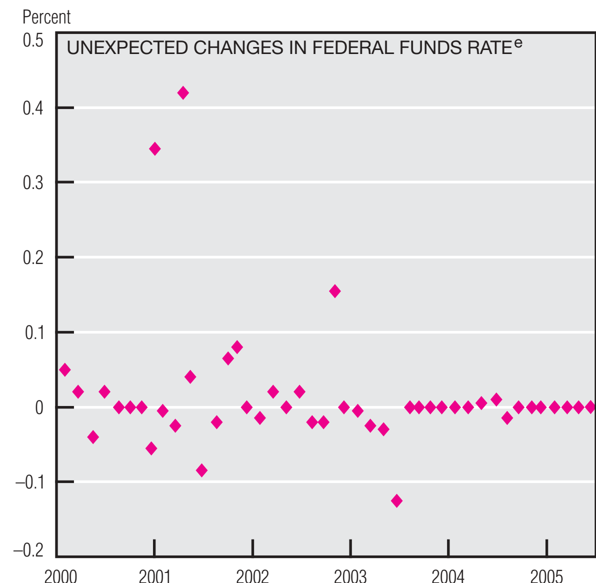
Monetary Policy *(cont.)*









a. Defined as the effective federal funds rate deflated by the core PCE Chain Price Index.
b. Shaded bars indicate periods of recession.
c. One day after the FOMC meeting.
d. Probabilities are calculated using trading-day closing prices from options on October 2005 federal funds futures that trade on the Chicago Board of Trade.
e. Difference in the federal funds futures the day before and the day of FOMC meetings since 1998.
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.

John Taylor, posits that the funds rate is a reaction to a weighted average of inflation and deviations in output from its potential. Compared with what the Taylor rule suggests, monetary policy has been easy; recent increases have steadily closed the gap, however, so that the funds rate is back in the predicted range, albeit at the lower end.

Another useful rule looks at the real federal funds rate, that is, the funds rate less inflation. After fluctuating around zero for two and a half years, it has now moved sharply upward, though it remains well below its late 1990s level.

These rules provide a strategic view of monetary policy, but many people are more interested in the tactical question of what is happening next. One good gauge of the market consensus is the futures market for the federal funds rate, which indicates that sentiment is clustered around 3.5% for August's meeting and 3.75% for September's. Data from the options market on fed funds futures show a broader range of opinion, though, with almost a third expecting a pause before the rise to 3.75%.

Tactically, of course, the FOMC has signaled its intentions quite clearly over the past two years. In fact, since mid-2003, the funds futures market has rarely been surprised by announcements from the FOMC. It has sometimes been a different story in the past, particularly at the two intermeeting moves of January 3 and April 18, 2001, when the target rate was reduced by 50 basis points.