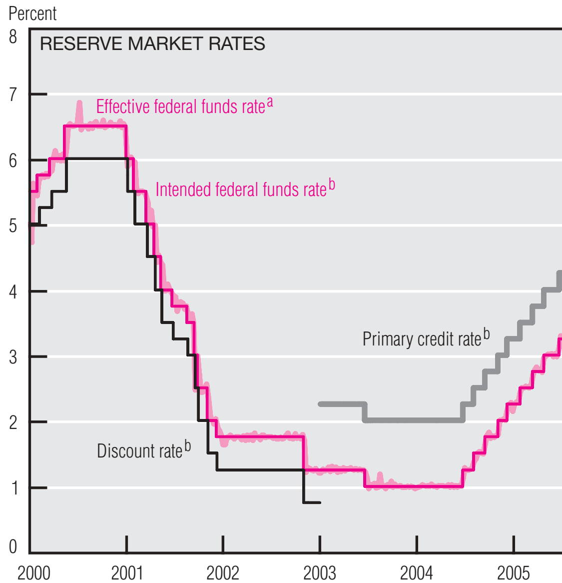
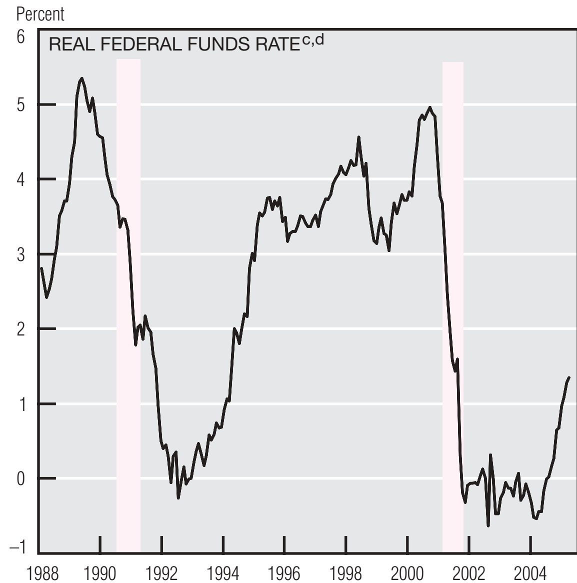
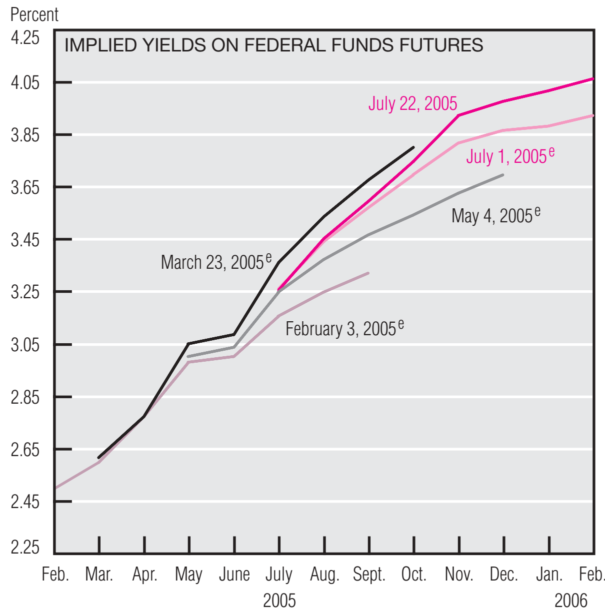
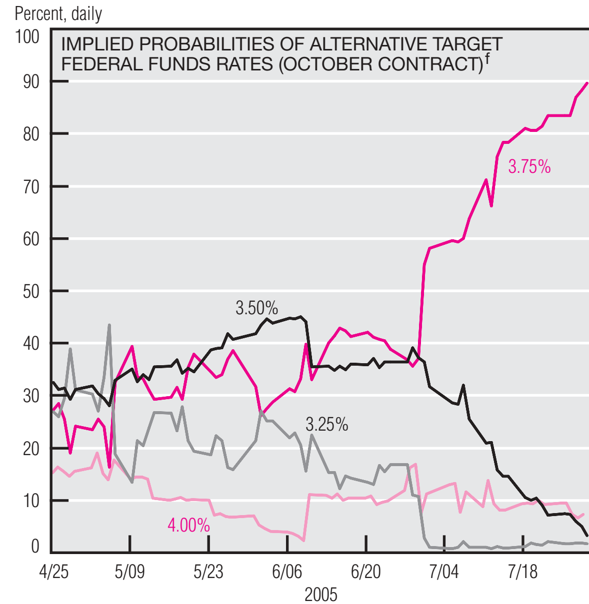
Monetary Policy









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 July 2005 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.

After each of its meetings, the Federal Open Market Committee (FOMC) releases a statement to explain its decision on the federal funds rate—a benchmark for all short-term interest rates. Analysts pore over these statements for signals of future policy actions. The statement following the June meeting said that "the Committee believes that policy accommodation can be removed at a measured pace," signaling a continuation of the recent pattern of rate hikes in 25 basis point increments.

In the early stages of the current economic expansion, the real (inflation-adjusted) fed funds rate was maintained near zero because the recovery remained questionable. It was widely understood, however, that such a policy stance could not be sustained without inducing inflationary pressures. By June 2004, the expansion clearly had gained sufficient traction, and the FOMC embarked on its "measured pace" policy.

Analysts also examine closely both the FOMC meeting minutes, which are now released three weeks after the meeting, and the semiannual Congressional testimony of Chairman Alan Greenspan. In his July 20 testimony before the House Banking Committee, Chairman Greenspan noted that "[o]ur baseline outlook for the U.S. economy is one of sustained economic growth and contained inflation pressures. …In our view, realizing this outcome will require the Federal Reserve to continue to remove monetary accommodation." The minutes showed that

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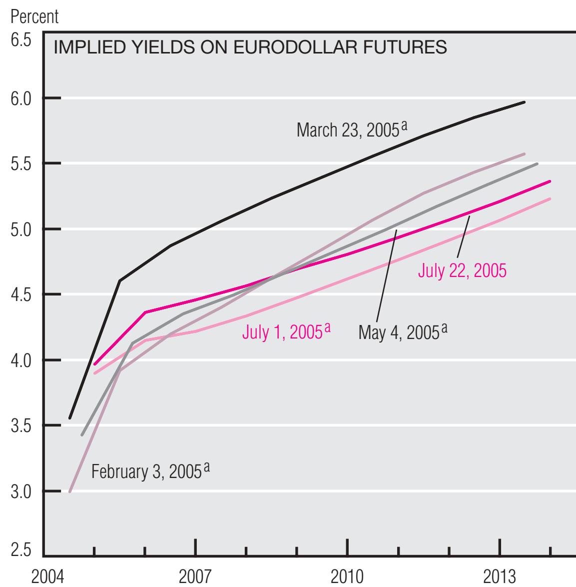
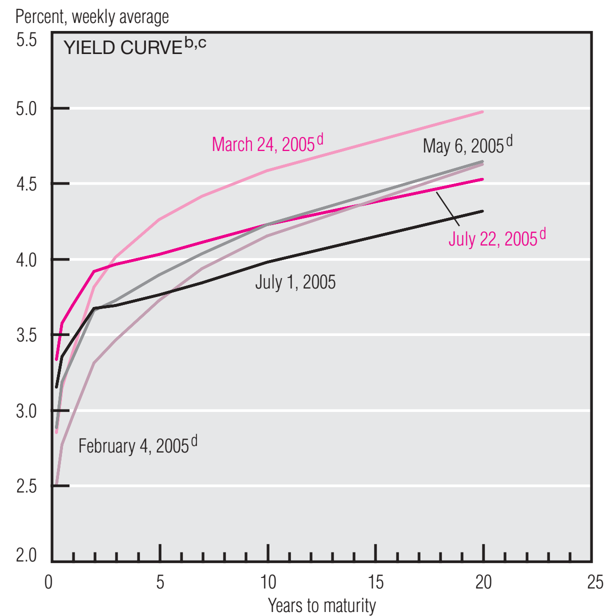
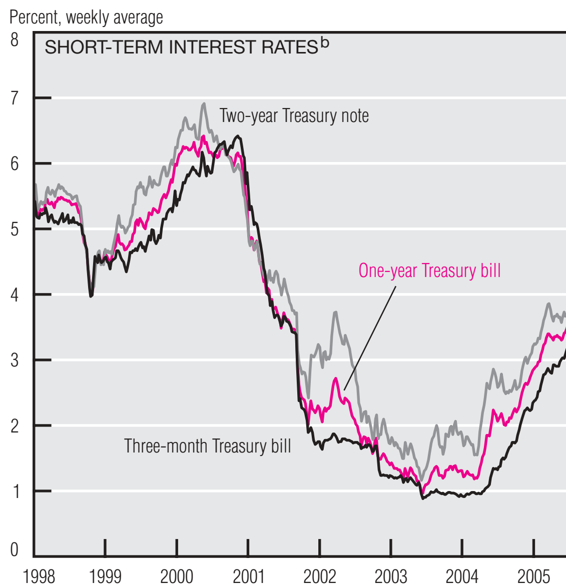
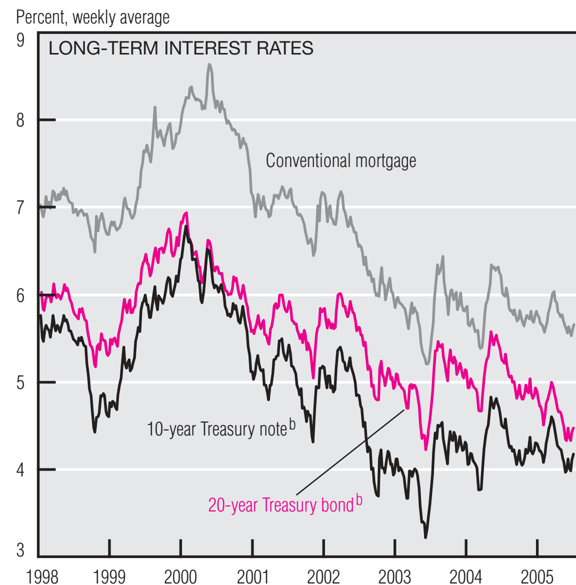
Monetary Policy *(cont.)*









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.
SOURCE: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

members of the FOMC believed that "[a]dditional tightening would probably be necessary, but views differed on the amount of tightening that would likely be required."

These remarks and the content of the minutes released the following day seem to have reinforced a growing expectation that the measured pace approach would be maintained at least through the summer. At the end of July, the implied yields on fed funds stood at levels consistent with two increases of 25 basis points, one each at the August and September meetings. Moreover, options on fed funds futures suggested four-to-five odds that the fed funds rate would be at 3.75% after the September FOMC meeting. The odds have favored such a target level since immediately after the last meeting.

Contained inflation expectations have allowed a somewhat attenuated elimination of policy accommodation. Market participants understand, however, that at some point the funds rate will approach a level consistent with a more neutral policy stance. Futures and options prices reveal a likely pause in rate hikes sometime in the fall. But with additional rate hikes, that would leave the fed funds rate around 4% at the end of the year.

With the balance of business news in July indicating a robust economy, interest rates rose across the maturity spectrum. Bond rates, which have been puzzlingly low, inched up some. The yield curve became slightly steeper than it was just after the FOMC meeting, and the bond rate conundrum, recently so mystifying, now seems somewhat less so.