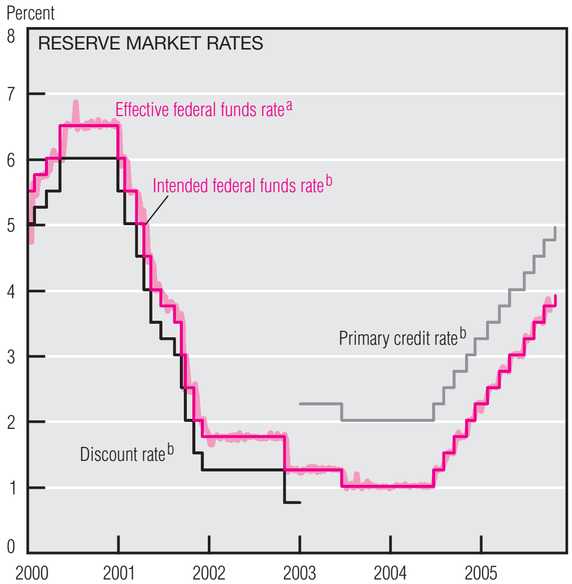
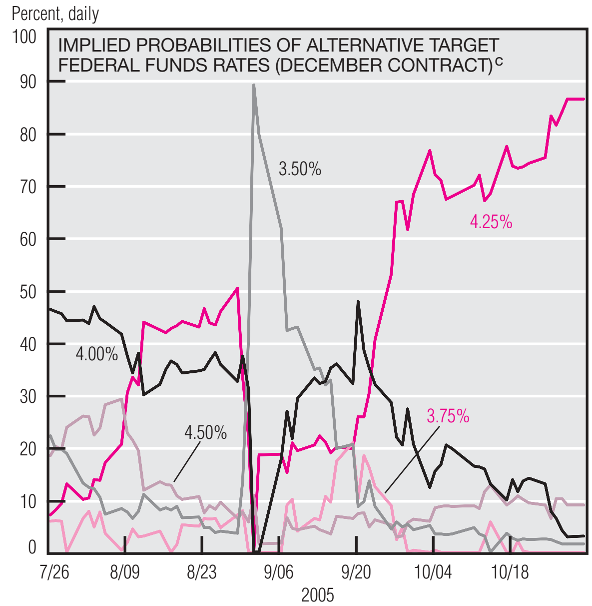
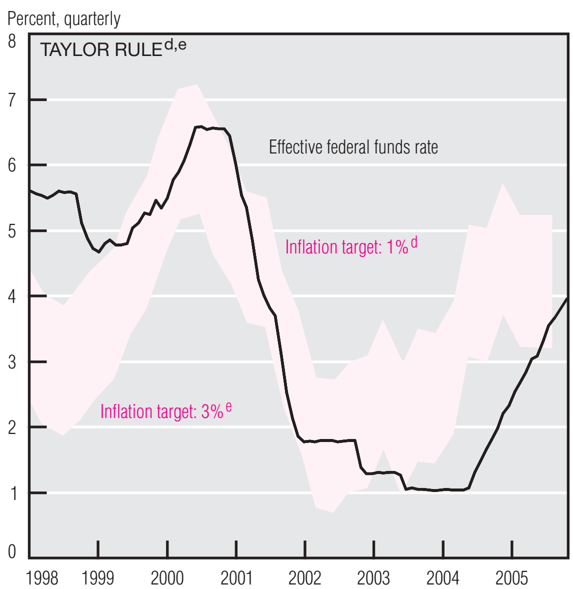
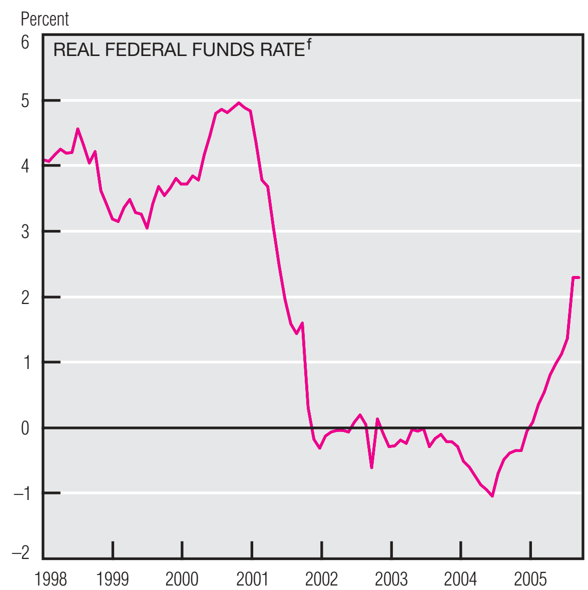
Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated using trading-day closing prices from options on December 2005 federal funds futures that trade on the Chicago Board of Trade.
d. This line assumes an interest rate of 2.5% and an inflation target of 1.0%.
e. This line assumes an interest rate of 1.0% and an inflation target of 3.0%.
f. Defined as the effective federal funds rate deflated by the Core Personal Consumption Expenditures Index.
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.

With the November 1 increase, the Federal Open Market Committee has increased the target federal funds rate by 25 basis points for 12 meetings in a row, bringing the rate from 1.00% in June 2004 to 4.00%. The target last reached this level in May 2001. Market participants do not expect a letup anytime soon: Implied probabilities from options on federal funds futures see an 85% chance that the target will be 4.25% in December. Significantly, two-thirds of the 15% who disagree are expecting the target to jump to 4.50%.

Looking exclusively at rates detaches the problem from the broader contexts of the general economy. One such context is the Taylor rule, which views the fed funds rate as a reaction to a weighted average of inflation, target inflation, and economic growth. Compared with what the Taylor rule would suggest, monetary policy over the past several years has been easy, but recent increases have steadily closed the gap, bringing the rate back near the middle of the predicted range. Another approach is to compare the target with inflation, producing a real (that is, inflation-adjusted) federal funds rate. This has now moved strongly into positive territory after nearly three years in the negative range, confirming the FOMC's statements that it has been removing policy accommodation that was initially adopted to quell economic weakness and ward off deflation.