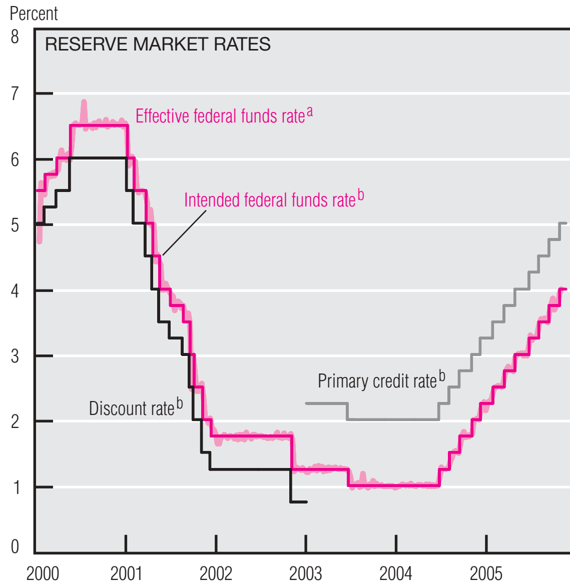
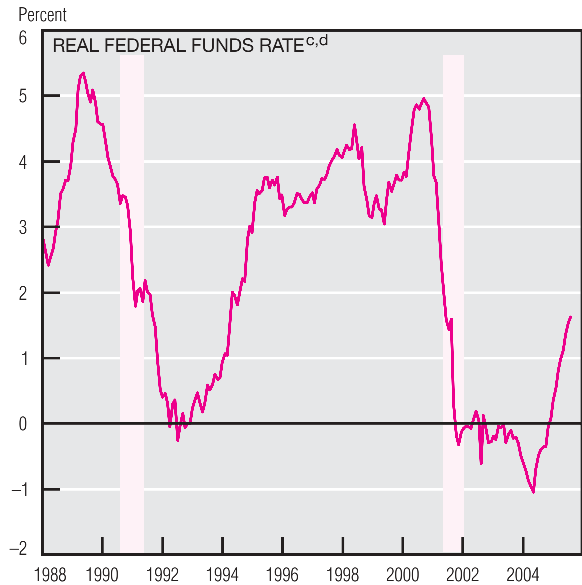
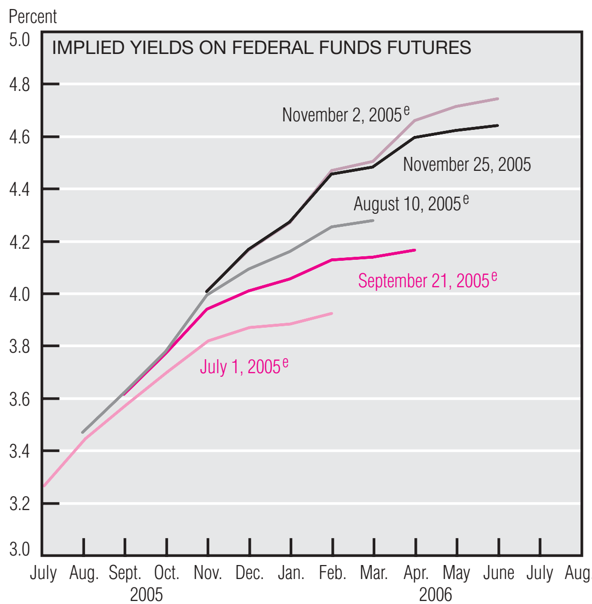
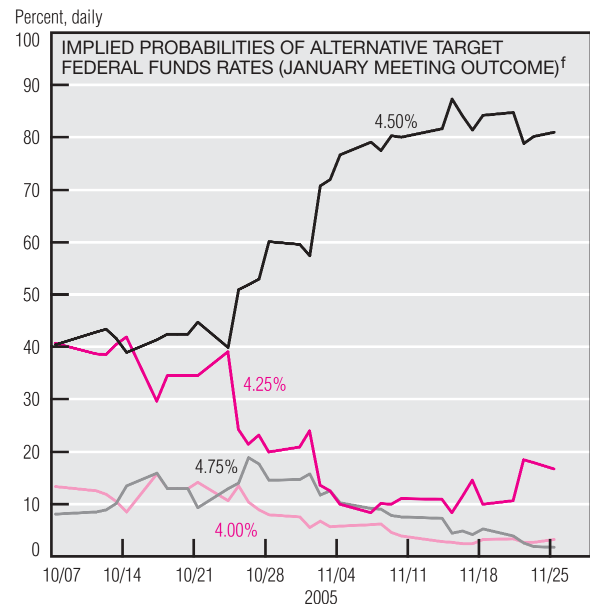
Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Defined as the effective federal funds rate deflated by the recent annual (that is, trailing) 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 February 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.

At its November 1 meeting, the Federal Open Market Committee (FOMC) raised its federal funds rate target from 3.75% to 4%, which is still less than 2 percentage points above the core inflation rate of personal consumption expenditures for the past year. The rate hike was widely anticipated.

Because the most recent annual core inflation rate is often viewed as a proxy for expected future inflation, the difference between the fed funds rate and core inflation rate is commonly used to measure the real (inflation-adjusted) fed funds rate. However, in light of hurricane-related inflation concerns, trailing core inflation might be a questionable proxy for inflation expectations. Indeed, the inflation expectations revealed in other, more prospective, measures—such as those from survey data or market yields on inflation-protected securities—are currently higher than recent inflation levels. Hence, a real fed funds rate based on trailing inflation may be an overestimate. This would suggest that a greater degree of policy accommodation remains.

The November policy move was consistent with the forward-looking language offered in recent statements. For more than a year now, the FOMC policy statement has repeated that "the Committee believes that policy accommodation can be removed at a measured pace." The fed funds rate

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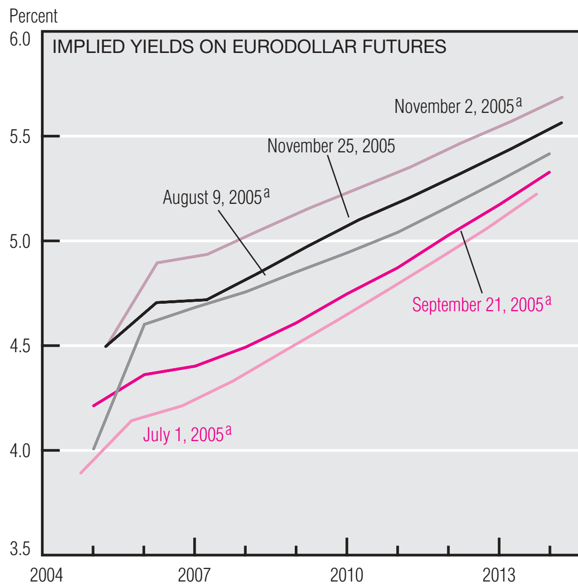
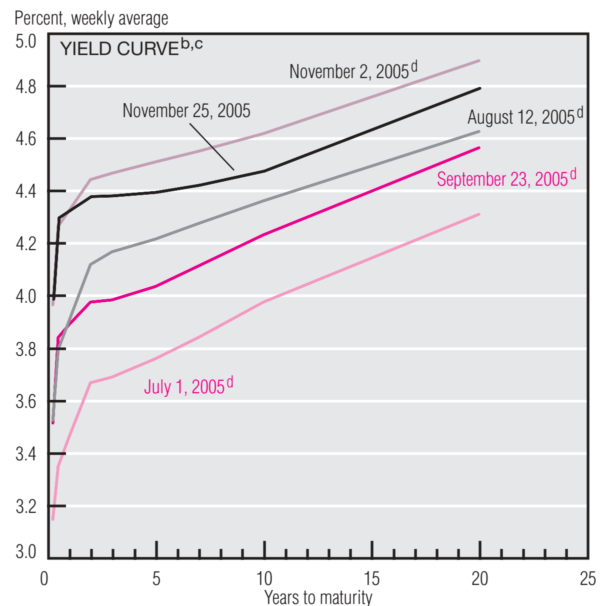
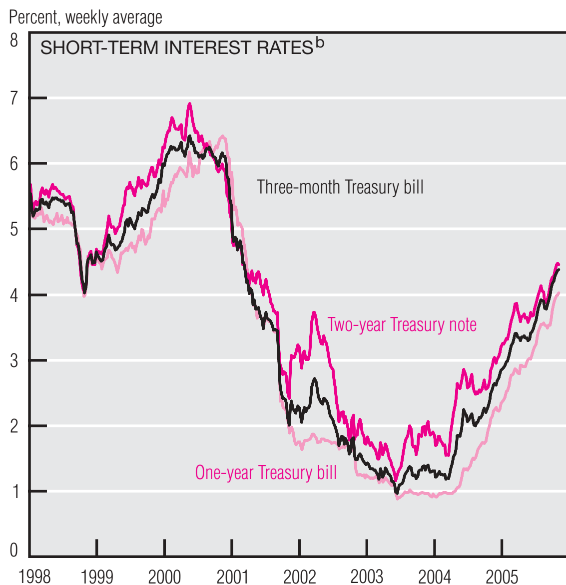
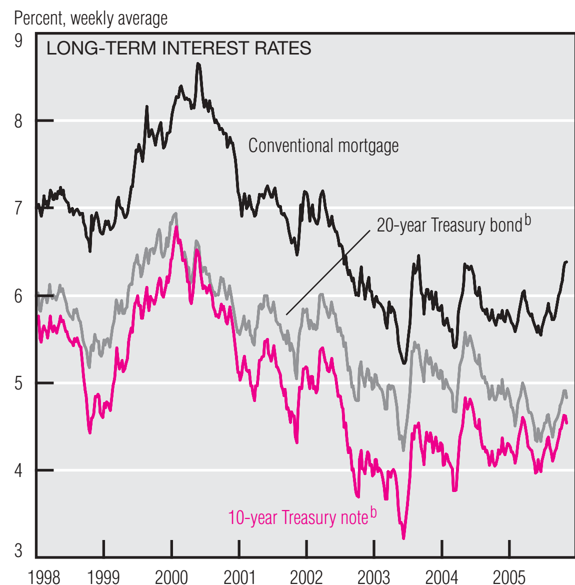
Monetary Policy *(cont.)*









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.

has risen in increments of 25 basis points at each FOMC meeting without a hint of when a pause might occur.

The minutes of the November meeting, released with a three-week lag, seemed to make preparations for removing the "measured pace" language. Analysts focused on this sentence: "Several aspects of the statement language would have to be changed before long, particularly those related to the characterization and outlook for policy." However, prices of fed funds futures and options on those futures suggest that market participants do not expect dramatic changes in the language. Rather, a pause in rate hikes sometime next spring had already been priced into these instruments.

Implied yields based on the prices of fed funds futures indicate that the funds rate is expected to rise to between 4.5% and 4.75% by April. Moreover, options on these futures suggest that rate hikes of 25 basis points each at the December and January meetings remain very likely. Thus the release of the minutes seemed to have only a marginal effect on when market participants expected a pause. After the minutes were released, investors were giving slightly higher odds that the pause would be announced at the March meeting.

Yields on Treasury bonds tended to fall after the release, but only marginally. On the whole, financial markets seem fairly confident that hurricane-related inflation concerns will come to pass, and that policy may be approaching a more neutral setting.