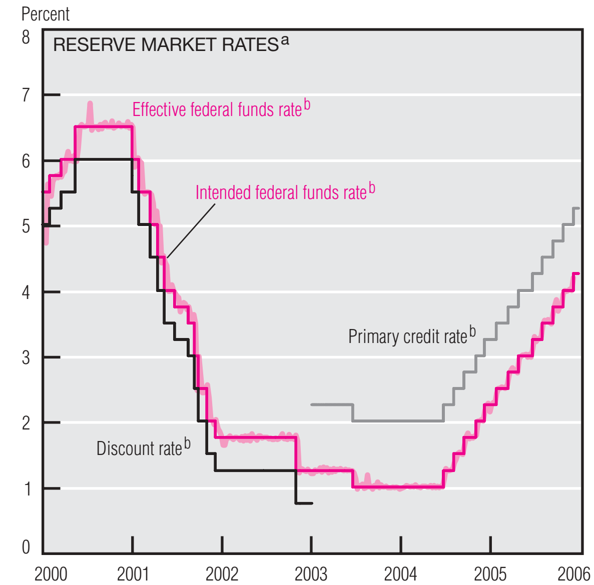
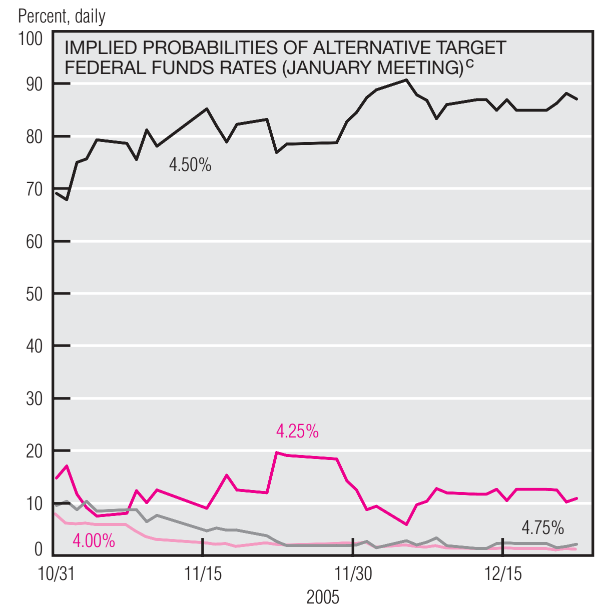
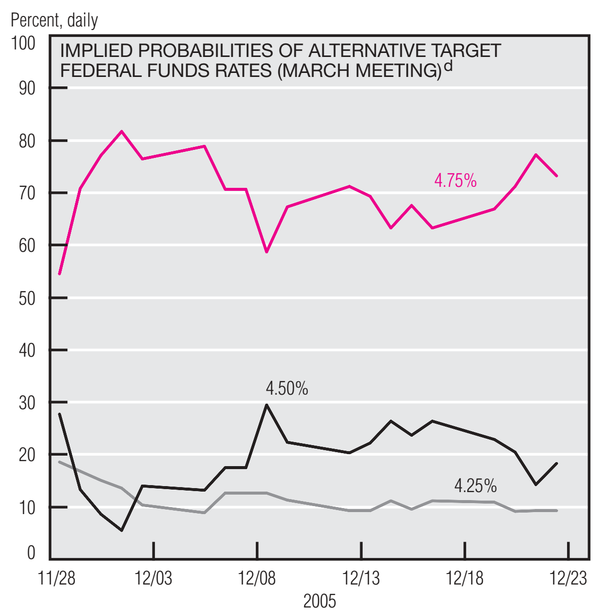
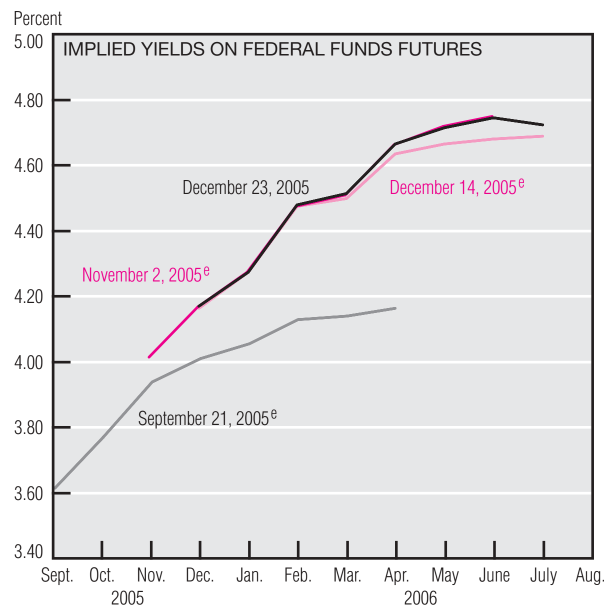
Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated using trading-day closing prices from options on February 2006 federal funds futures that trade on the Chicago Board of Trade.
d. Probabilities are calculated using trading-day closing prices from options on March 2006 federal funds futures that trade on the Chicago Board of Trade.
e. One day after the FOMC meeting.
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 December 13, the Federal Open Market Committee (FOMC) raised the intended federal funds rate 25 basis points (bp) to 4.25%. Its press release stated that "the expansion in economic activity appears solid." Despite concerns that "increases in resource utilization" and higher energy prices might cause inflationary pressures, it noted that "core inflation has stayed relatively low," and inflationary expectations "remain contained."

Participants in the federal funds options market had little doubt as to the outcome of the December meeting: They had placed nearly a 94% probability on a 25 bp increase.

Participants appear to believe the FOMC's statement that "some further measured policy firming is likely." They currently place the highest probabilities on 25 bp funds rate increases at both the January and March meetings. In the first week of December, they became less certain about the future course of the funds rate. The probability associated with a 4.75% funds rate at the March meeting fell more than 20 percentage points, and the probability associated with a 4.50% funds rate rose correspondingly. Assuming that the rate would rise 25 bp in January, participants increasingly came to expect a pause in March. Since early December, much of the change in expectations has been erased.

As to future policy firming, some analysts have argued that by dropping the word "accommodation" and adding the word "some," the FOMC's statement foreshadows the end of this round of tightening. But market participants did not react strongly to these wording changes; they do not foresee a pause in the next two meetings.