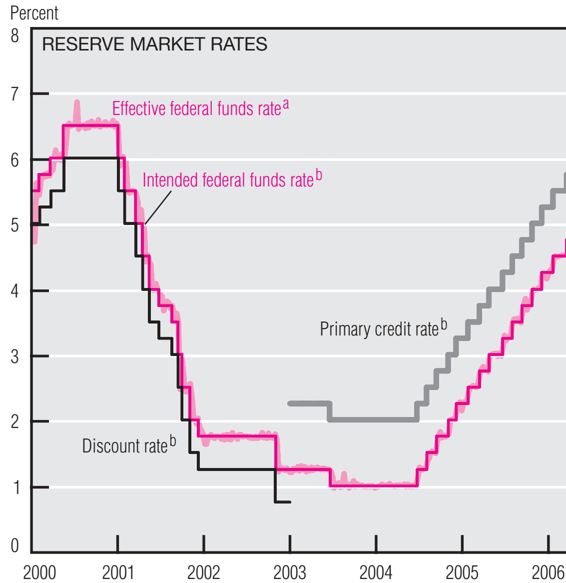
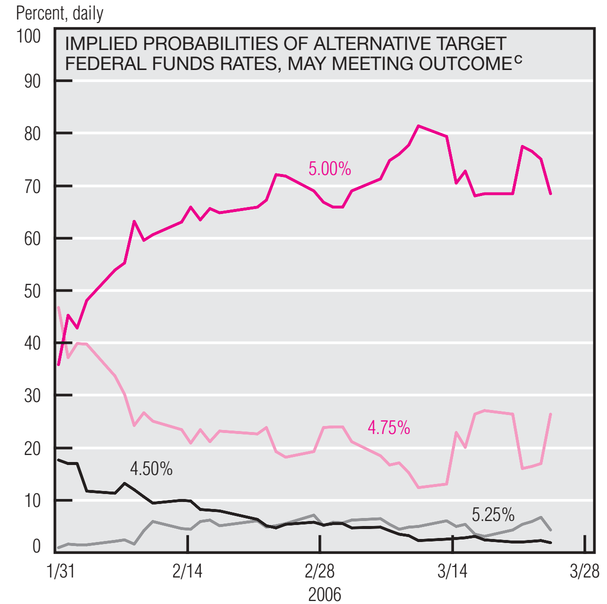
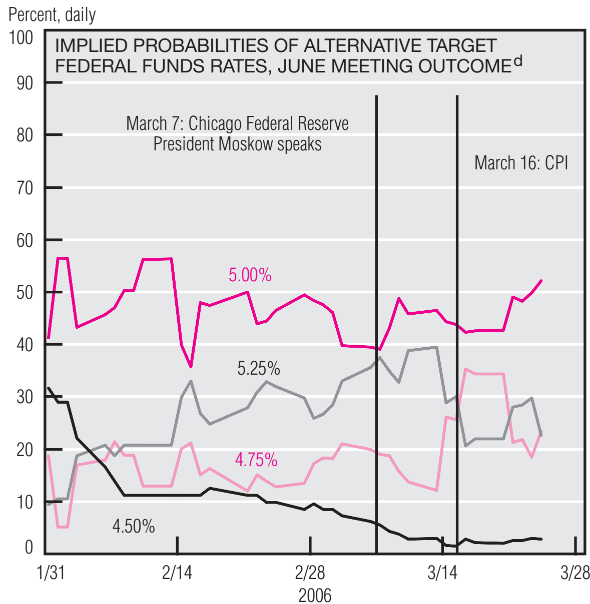
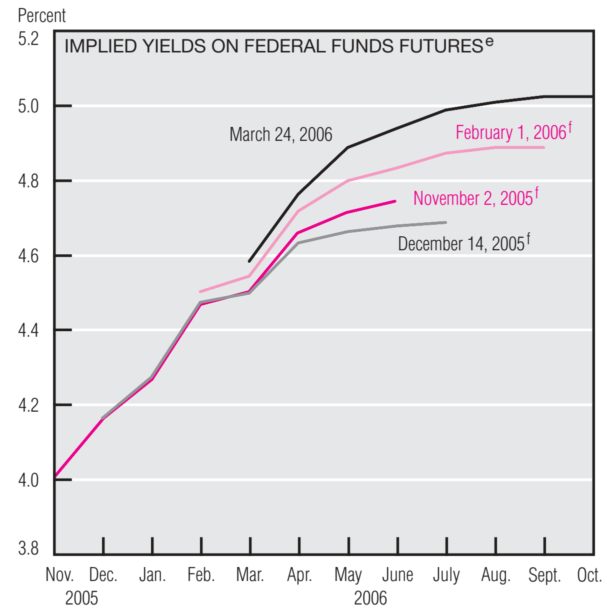
Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated using trading-day closing prices from options on May 2005 federal funds futures that trade on the Chicago Board of Trade.
d. Probabilities are calculated using trading-day closing prices from options on June 2005 federal funds futures that trade on the Chicago Board of Trade.
e. All yields are from the constant-maturity series
f. 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 March 28, the Federal Open Market Committee (FOMC) voted to raise the intended federal funds rate 25 basis points (bp) to 4.75%. This comes within 175 bp of its most recent high (6.50%), which it hit during the last business cycle peak in May 2000. The FOMC's March press release stated that "some further policy firming may be needed," although "the run-up in the prices of energy and other commodities appears to have had only a modest effect on core inflation."

Since the mid-February FOMC meeting, participants in the federal funds options market have been reasonably certain that the target rate will reach 5.00% at the May meeting, and they currently place nearly a 70% probability on that occurrence. However, the expected outcome of the June meeting is more doubtful. On March 7, Chicago Federal Reserve President Michael Moskow stated that monetary policy is "currently in this neutral range," but "even with the funds rate in the range of neutral, further changes in policy may be appropriate." Soon after this remark, the probability that the FOMC would pause at 5.25% increased 10 percentage points to nearly 50%. The benign March CPI report, which showed an increase of only 0.1% in both total and core inflation in February, kept the likelihood of a 5.00% rate in June but decreased the likelihood of a 5.25% rate. Currently, options participants place a probability of more than 50% that the FOMC will pause after

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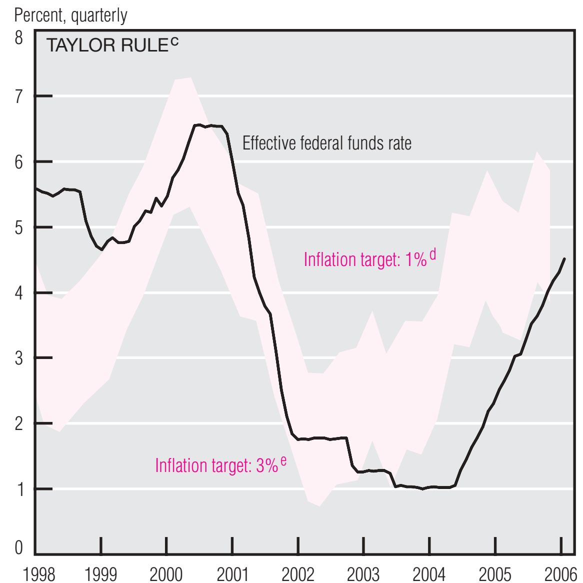
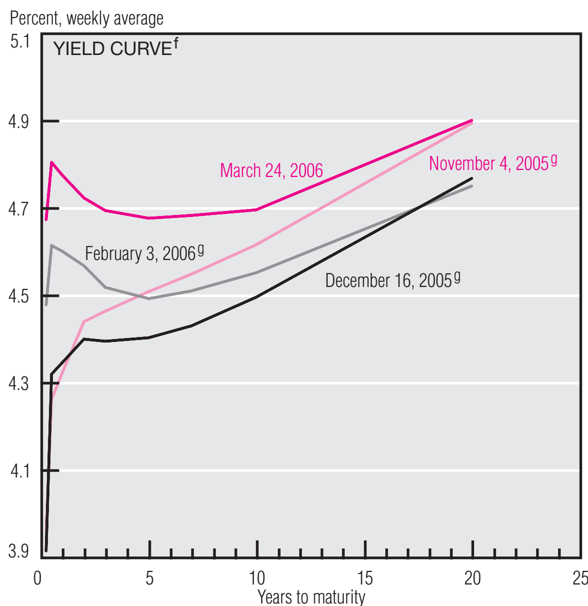
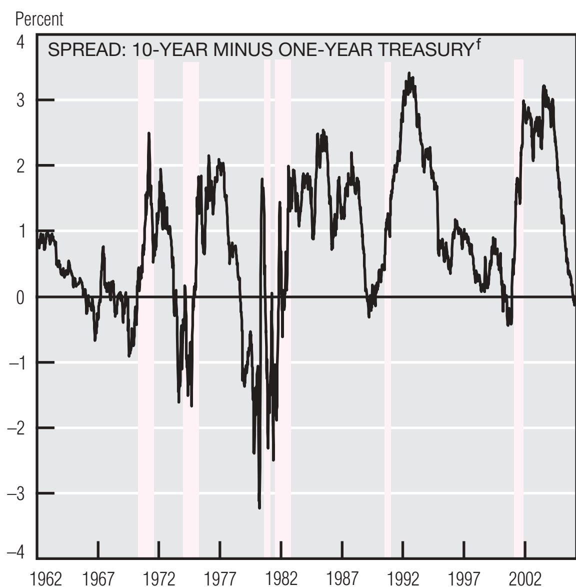
Monetary Policy *(cont.)*







a. Defined as the effective federal funds rate deflated by the core PCE.
b. Shaded bars represent periods of recession.
c. The formula for the implied funds rate is taken from the 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.
d. This line assumes an interest rate of 2.5% and an inflation target of 1%.
e. This line assumes an interest rate of 1.5% and an inflation target of 3%.
f. All yields are from the constant-maturity series.
g. Friday 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; and Bloomberg Financial Information Services.

the May meeting and only 25% that rates will continue to increase. Federal funds futures tell a similar story: They indicate that by July, the federal funds rate will plateau near 5.00%.

Since the current round of tightening began in June 2004, the target level has risen 375 bp. The inflation-adjusted federal funds rate currently stands at 2.5%, nearly 350 bp above its low in June 2004. The real federal funds rate has not increased 350 bp without interruption since 1992–95, after the 1990 recession.

As the real federal funds rate has grown, the nominal federal funds rate has moved well within the range recommended by the Taylor rule. This rule views the rate as a reaction to the weighted average of the deviation of inflation from its estimated long-run target and the output gap, the difference between output and its potential.

The yield curve continued to flatten in March and became inverted in some ranges. On the Friday after the January 31 FOMC meeting, the 10-year Treasury bond was 5 bp lower than the one-year Treasury note. By the end of March, the inversion had widened to 8 bp.

The state of the yield curve has become big news because yield curve inversions have often preceded recessions in the past. However, Chairman Bernanke has consistently stated, in his March 20 speech and during his February 15–16 testimony, that the current low long-term rates do not necessarily portend a major economic slowdown.