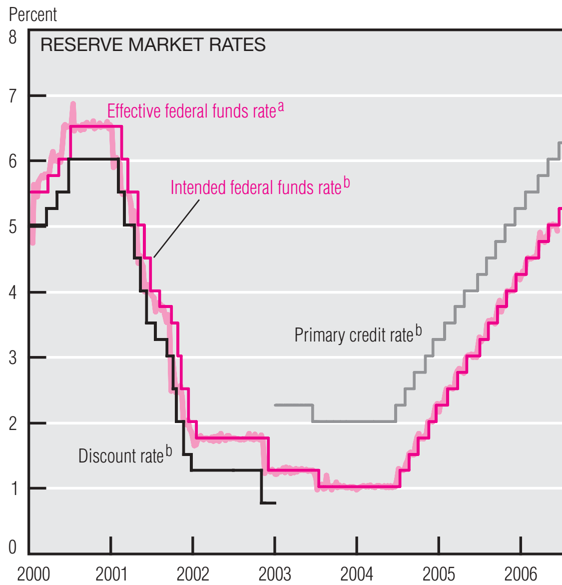
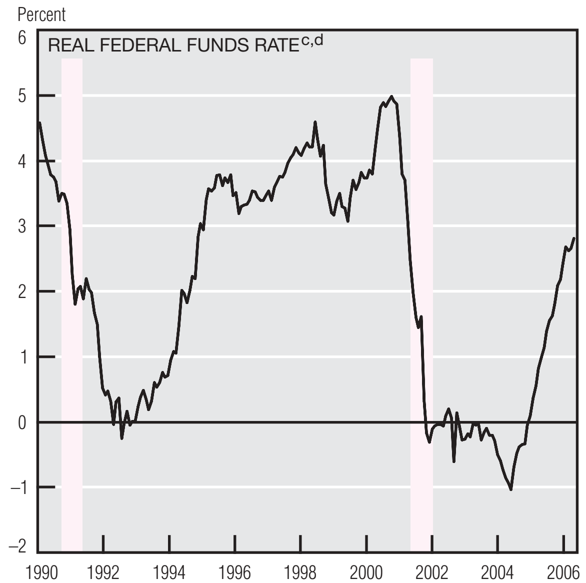
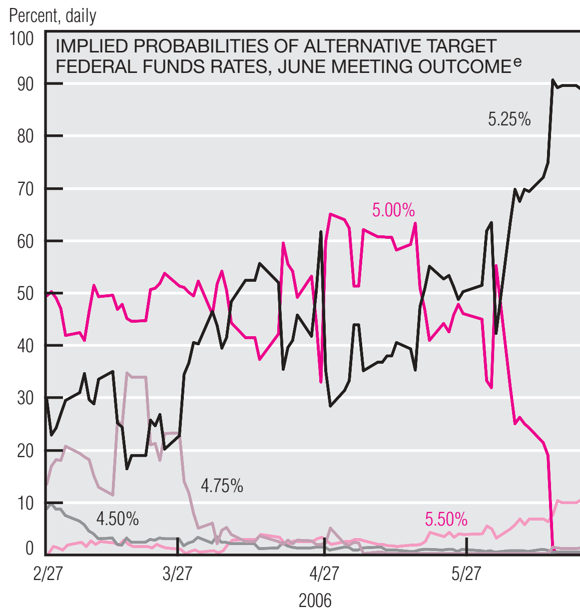
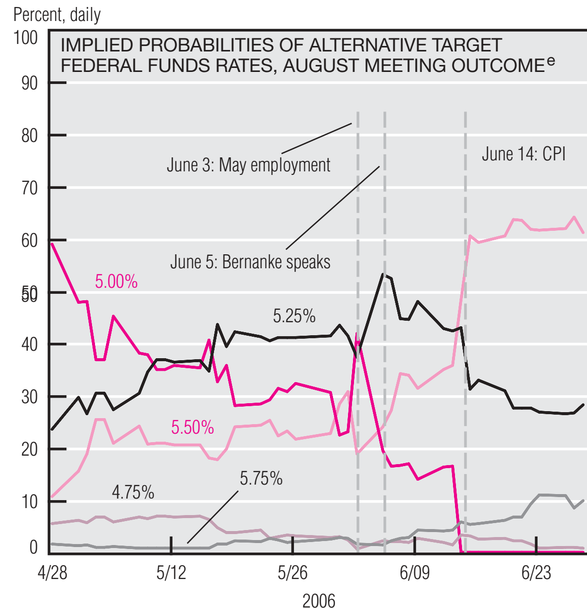
Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Defined as the effective federal funds rate deflated by the core PCE Chained Price Index.
d. Shaded bars indicate periods of recession.
e. Probabilities are calculated using trading-day closing prices from options on May 2006 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.

On June 29, the Federal Open Market Committee (FOMC) raised its target for the federal funds rate 25 basis points (bp), taking it to 5.25%. The inflation-adjusted (or real) fed funds rate now stands near 3%. The most recent policy action was widely anticipated, but uncertainty remains about the future course of policy.

Between the May and June FOMC meetings, analysts' expectations about policy shifted markedly, largely based on the understanding that future policy decisions were likely to be data dependent. Financial market participants sift through incoming economic reports and speeches by Federal Reserve officials to formulate expectations about policy actions at upcoming meetings. More precisely, analysts assess how such information could change the FOMC's outlook and thus affect the likelihood of alternative policy outcomes.

Sometimes the effects are transitory, as they appeared to be after the May employment report was released on June 3. At other times, the effects on the distribution of market opinion are more permanent. This is often the case after a surprising inflation report because price stability is a key goal for the Federal Reserve. The CPI release on June 14 illustrates the point: The new inflation numbers seemed to be unexpectedly strong and broad based, causing analysts to revise their expectations of how the FOMC would react. After the report,

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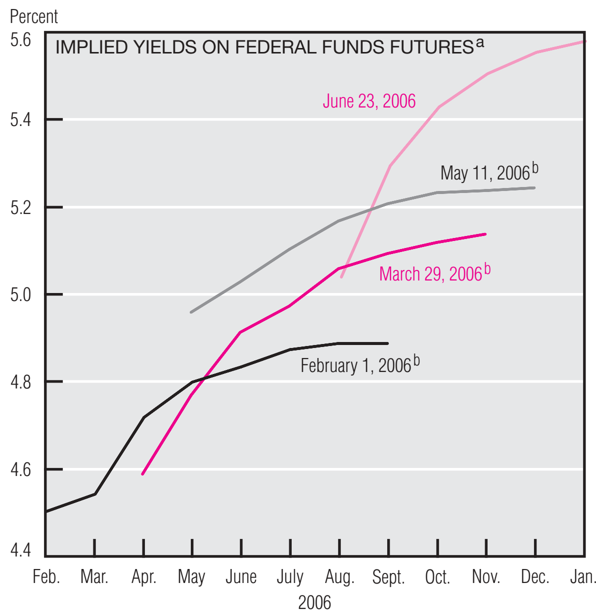
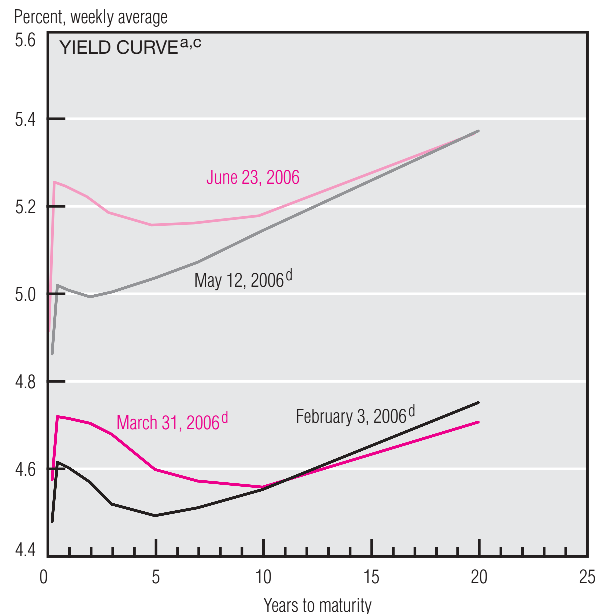
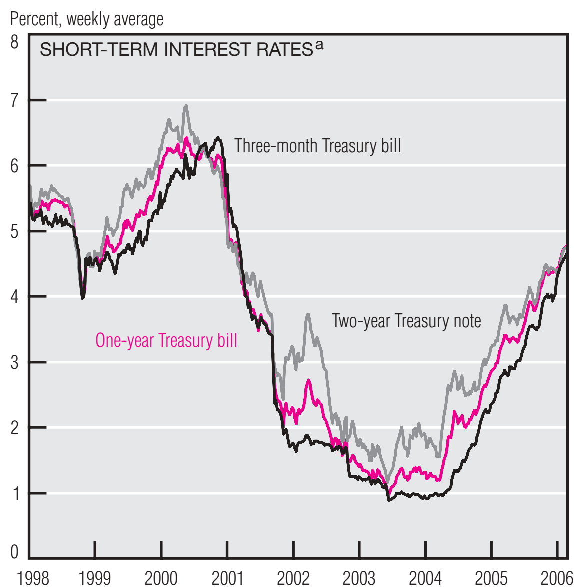
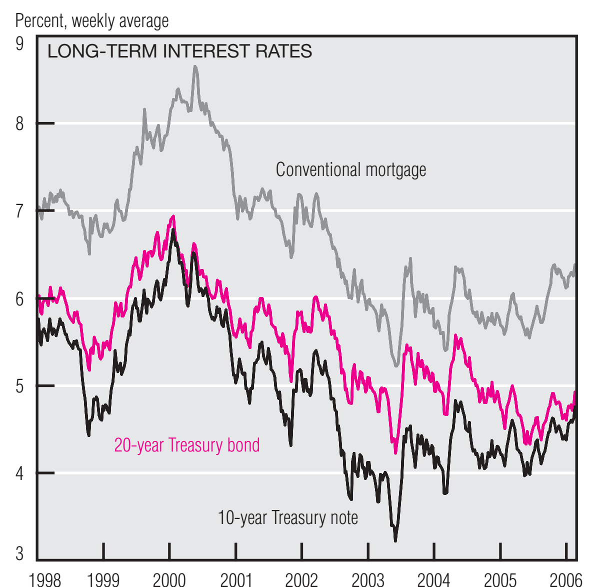
Monetary Policy *(cont.)*









a. Yields are from constant-maturity series.
b. One day after the FOMC meeting.
c. Average for the week ending on the date shown.
d. First weekly average available after the FOMC meeting.
SOURCES: Board of Governors of the Federal Reserve System, “Selected Interest Rates,” *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

analysts became certain there would be a rate hike at the June meeting. Moreover, the odds of another rate hike at the August 8 meeting went from even to likely.

Market commentary suggests that changes in the distribution of expected policy outcomes were somewhat shaped by concerns expressed in recent speeches by Federal Reserve officials, who have used words like “unwelcome,” “bothersome,” and “uncomfortable” to describe the inflation report. Thus, market participants’ response seems to confirm a belief that the FOMC will take whatever policy actions are required to assure price stability.

At this time, the prices of fed funds futures imply that another rate hike in August would take the funds rate very near a level where it will plateau. However, as we have seen in the past, markets are often surprised—and in both directions. An August increase is not set in stone. Potential lagged effects of cumulative policy tightening might turn out to be sufficient to contain inflation.

Since the initial hike in 2004, the fed funds rate has risen more than four percentage points. Short-term interest rates—such as those on home-equity credit lines—have increased in lockstep with policy rates. Longer-term rates—such as those on home mortgages—have also risen, but to a far lesser extent. Ultimately, however, higher borrowing costs are expected to be associated with both a moderation in economic growth and lower inflation.