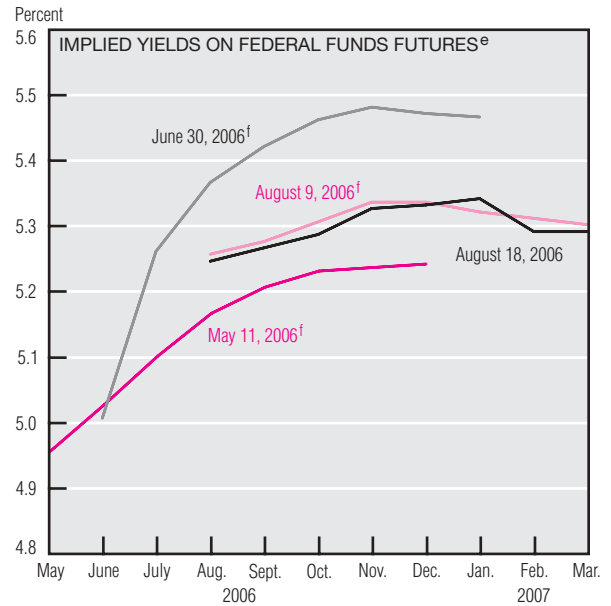
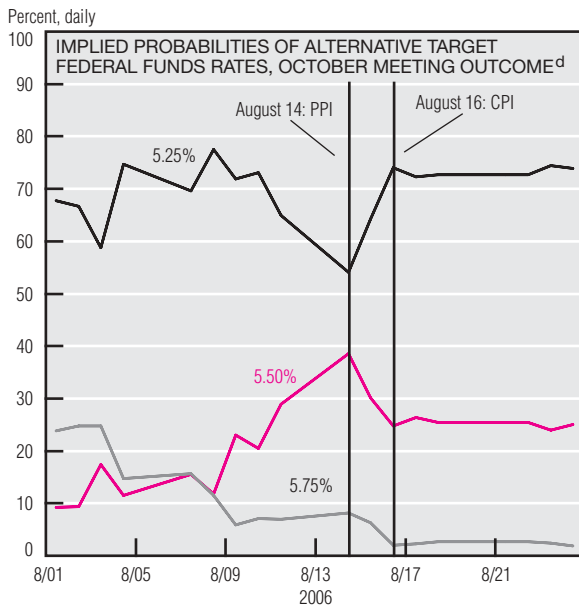
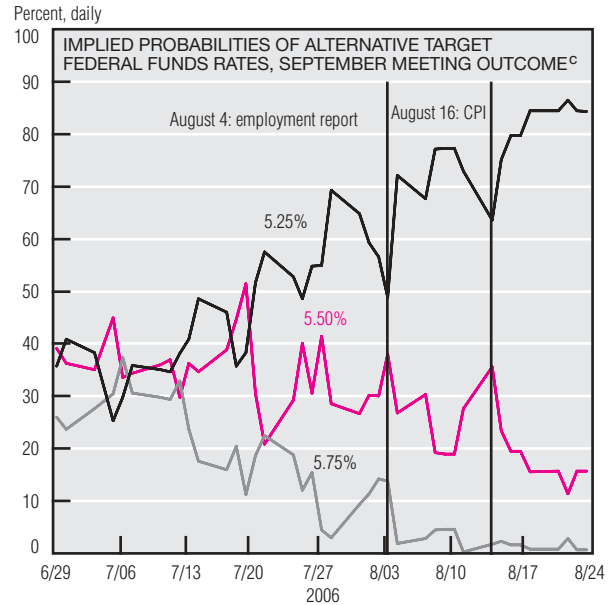
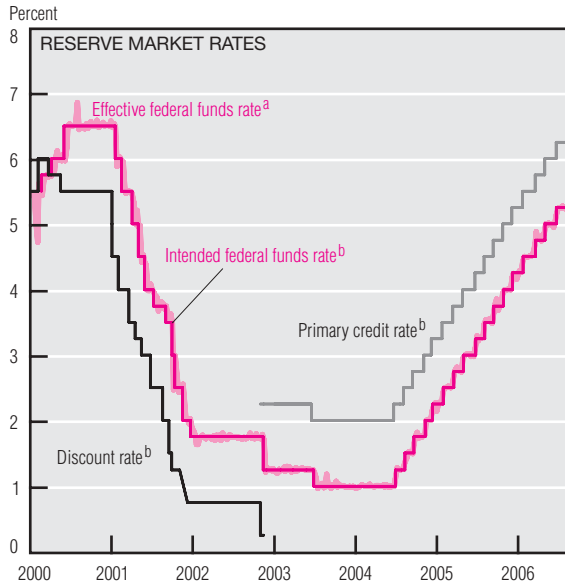


Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. Probabilities are calculated using trading-day closing prices from options on September 2006 federal funds futures that trade on the Chicago Board of Trade.

d. Probabilities are calculated using trading-day closing prices from options on October 2006 federal funds futures that trade on the Chicago Board of Trade.

e. All yields are from 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 August 8, the Federal Open Market Committee (FOMC) voted to leave the federal funds rate at 5.25%, the first pause since June 2004. Its statement cited slower economic growth and cooling in the housing market as the main reasons. Although "readings on core inflation have been elevated in recent months," the FOMC is confident that "inflation pressures seem likely to moderate over time." The statement's wording suggests that the path of future monetary policy is data dependent: "The

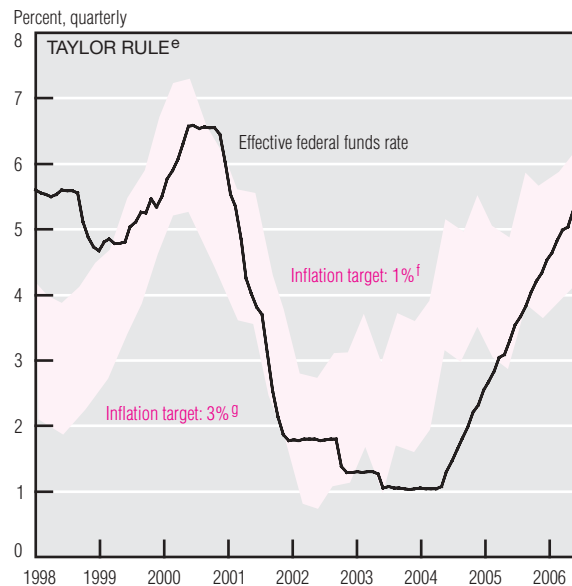
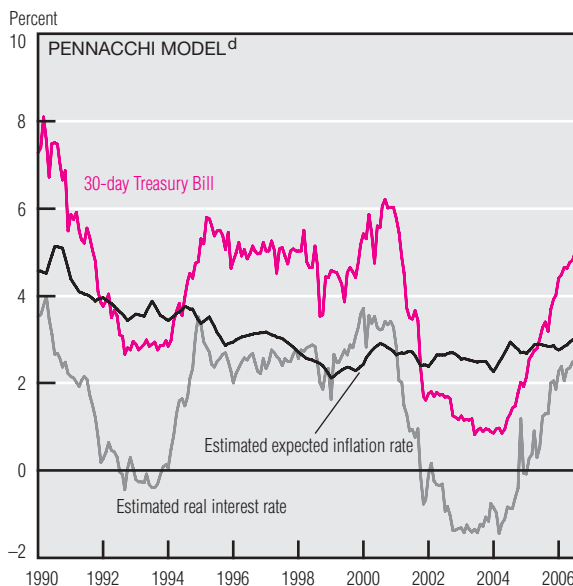
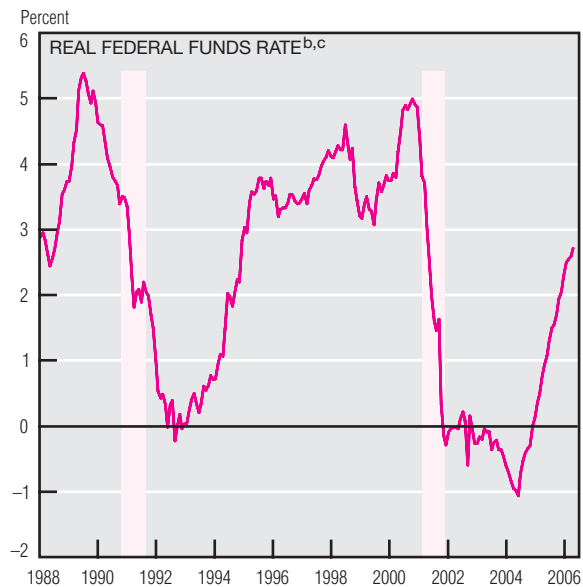
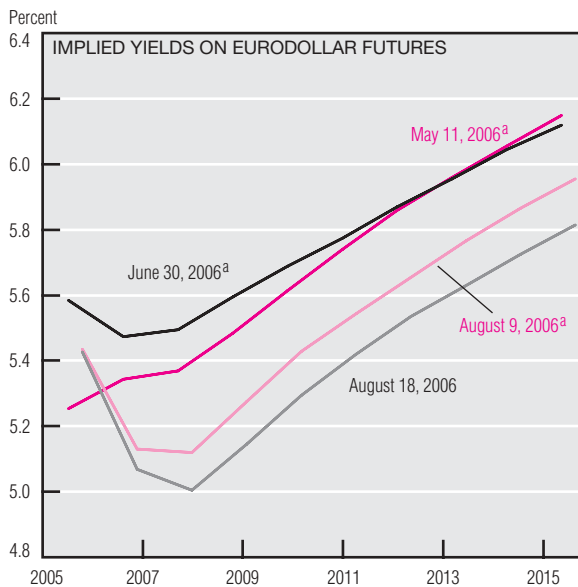
extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."

On August 3, participants in the federal funds options market placed the probability of no rate change at the September meeting at nearly 49%. The next day, after the employment report was released, that probability rose to almost 72%. By August 22, it had soared above 86%.

The implied probabilities for the October 24 meeting have remained fairly constant since the August 16 CPI release: 72% odds of a 5.25% outcome and roughly 25% odds of a 25 basis point (bp) hike. Recent implied yields on federal funds futures echo this belief in a continued pause. The August 9 and August 18 implied yields are very similar, indicating a constant policy stance well into the first quarter of next year.

(continued on next page)

Monetary Policy (cont.)



a. One day after FOMC meeting.

b. Defined as the effective federal funds rate deflated by the core PCE.

c. Shaded bars represent periods of recession.

d. The estimated expected inflation rate and the estimated real interest rate are calculated using the Pennacchi model of inflation estimation and the median forecast for the GDP implicit price deflator from the Survey of Professional Forecasters. Monthly data are used.

e. 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.

f. Assumes an interest rate of 2.5% and an inflation target of 1%.

g. Assumes an interest rate of 1.5% and an inflation target of 3%.

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; Federal Reserve Bank of Philadelphia; and Bloomberg Financial Information Services.

The implied yields on Eurodollar futures, which provide a longer-run gauge of expected monetary policy, are consistent with the federal funds rate pause indicated by the implied probabilities for the September meeting. However, long-term expectations suggest that the federal funds rate target will drop from 5.25% to 5.00% later in 2007.

Real yields provide another policy gauge. The real federal funds rate, the

effective rate deflated by the core personal consumption expenditures (PCE) price index, stands at roughly 2.5%. During the most recent tightening cycle, the real federal funds rate increased by roughly 360 bp.

This movement in the real funds rate is corroborated by the Pennacchi model, which adjusts for inflation statistically, using survey expectations and estimates for both the expected inflation rate and the estimated real

funds rate. The latter, at 2.5%, is the same as the estimate given by the PCE deflator and is 1 bp shy of 3% for the year ahead.

The Taylor rule, which views the funds rate as reacting to a weighted average of inflation, target inflation, and economic growth, indicates the appropriateness of current monetary policy. According to this model, the current stance is consistent with an inflation target between 1% and 3%.