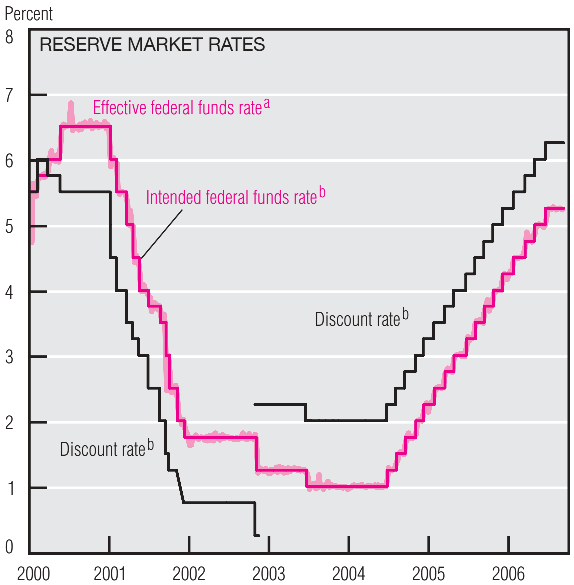
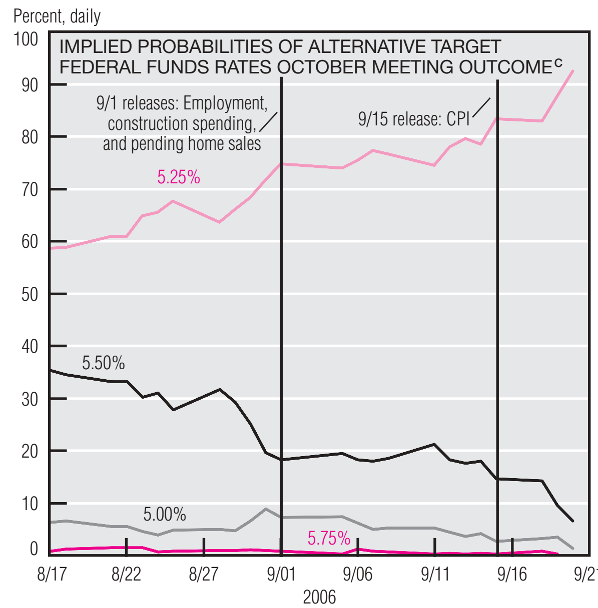
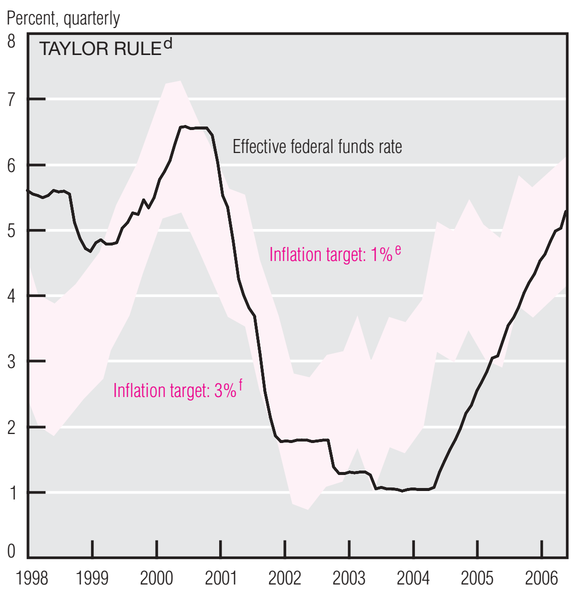
Monetary Policy







a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated using trading-day closing prices from options on October 2006 federal funds futures that trade on the Chicago Board of Trade.
d. 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.
e. This line assumes an interest rate of 2.5% and an inflation target of 1%.
f. This line assumes an interest rate of 1.5% and an inflation target of 3%.
g. Defined as the effective federal funds rate deflated by the core PCE Chained Price Index.
h. Shaded bars represent recessions.
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 the Chicago Board of Trade.

The Federal Open Market Committee left the target federal funds rate unchanged at 5.25% on September 20, the second meeting in a row with no change. Likewise, the Board of Governors left the discount rate at 6.25%. Whether this represents a "pause," with rates later moving in the same direction, as in 2002, or a "stop," with rates reversing direction, remains to be seen.

Certainly the market does not expect any immediate moves. The probabilities implied by the options on federal funds futures show a greater than 90% probability that the FOMC will again leave the rate unchanged at its October meeting.

A proper appreciation of policy requires putting the pause in a broader context. One such context is provided by the Taylor rule, which views the fed funds rate as a reaction to the weighted average of inflation, target inflation, and economic growth. The exact level prescribed by the rule depends on assumptions about the economy and on the preferred inflation target. For most of the past year, the funds rate has remained within the range of values suggested by the Taylor rule, and it now sits squarely in the middle of the range.

A related perspective comes from looking at the real federal funds rate (the fed funds rate minus inflation). This too has moved steadily higher, although at 2.8%, it is still well below the 4.9% level reached in October 2000.