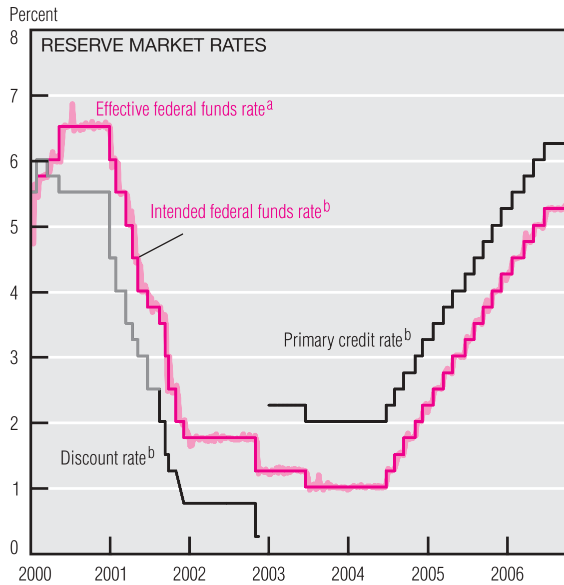
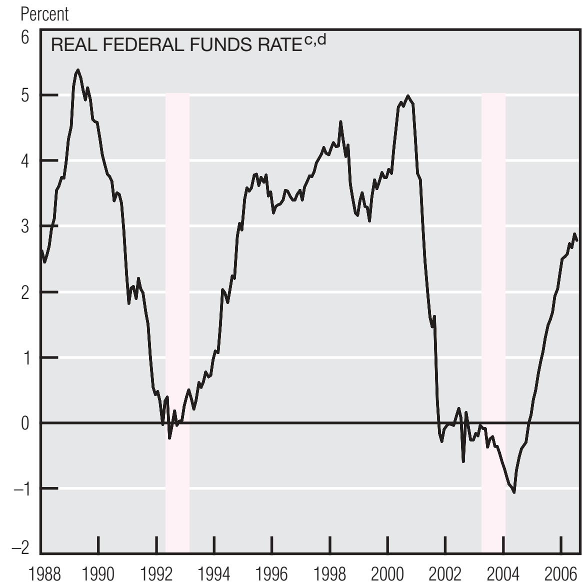
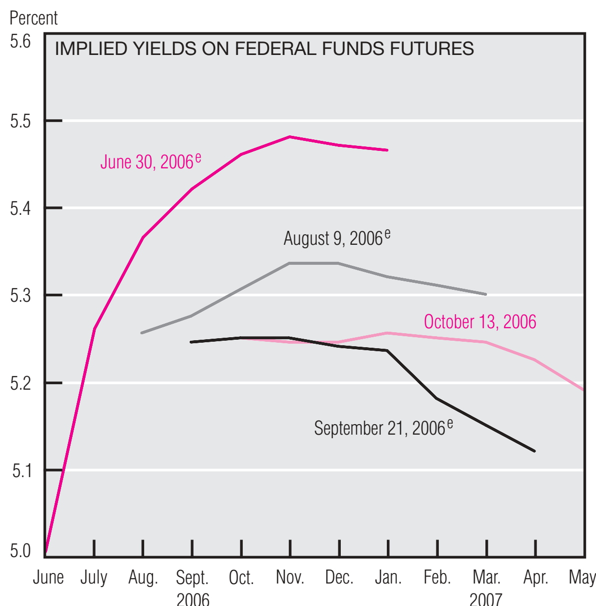
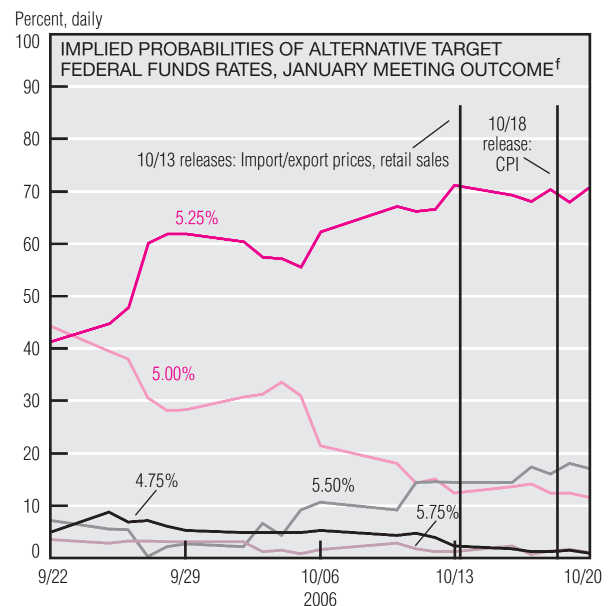
Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Defined as the effective federal funds rate deflated by the core PCE Chain Price Index.
d. Shaded bars indicate periods of recession.
e. One day after the FOMC meeting.
f. Probabilities are calculated using trading-day closing prices from options on January 2007 federal funds futures that trade on the Chicago Board of Trade.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; *USA Today*; and Bloomberg Financial Information Services.

The Federal Open Market Committee (FOMC) left the target federal funds rate at 5.25% on October 25, the third consecutive meeting with no change. The Board of Governors likewise left the primary credit rate unchanged at 6.25%. The real federal funds rate, defined as the effective federal funds rate less core PCE inflation, has shown signs of leveling off and now stands at 2.73%.

A mid-October survey by *USA Today* reported that about two-thirds of economist respondents said that current target rate was "just right." As for the direction of future policy, more than half expect the Fed to cut interest rates in the first half of 2007. As an alternative to the survey, real-time policy expectations may be derived from implied yields on federal funds futures and implied probabilities from options on these futures. Prices of such instruments reflect the opinions of investors with something at stake.

Implied yields on futures contracts in late winter have risen modestly since the last FOMC meeting, suggesting that rate cuts are not expected before spring. Historically, these estimates appear to have been biased slightly upward for horizons farther out than three months. The small bias is believed to be a term premium for risks associated with hedging.

Evaluating the implied probabilities derived from options on fed funds futures seems to indicate that, at least through February, the fed funds target will remain at 5.25% with a probability

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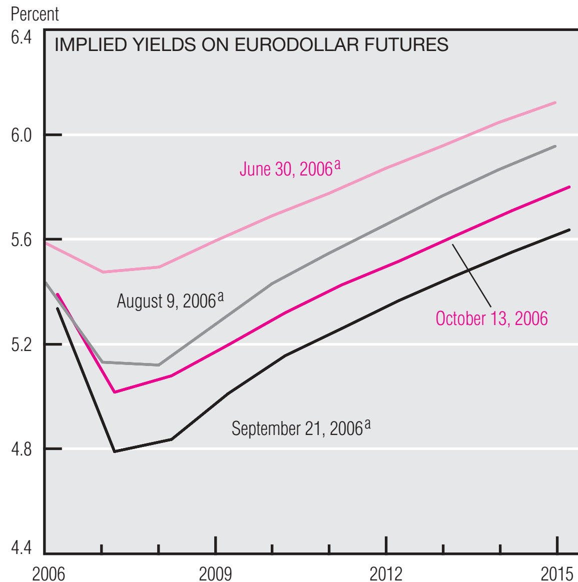
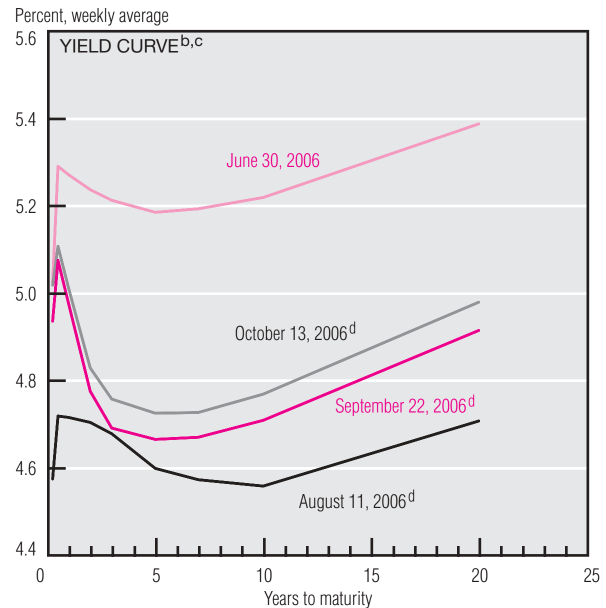
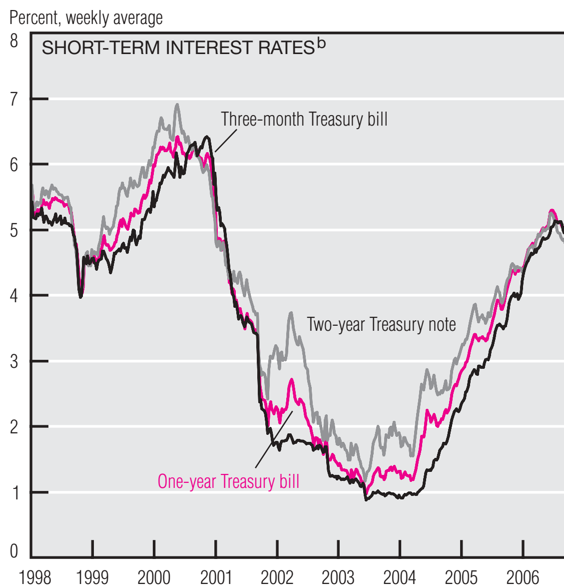
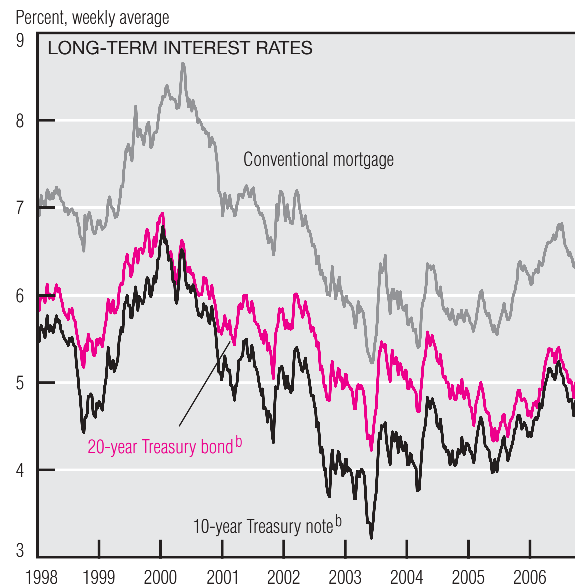
Monetary Policy *(cont.)*









a. One day after the FOMC meeting.
b. All yields are from constant-maturity series.
c. Average for the week ending on the date shown.
d. First weekly average available after the FOMC meeting.
SOURCE: Federal Reserve Board, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

of 70%. Moreover, the implied probabilities estimated most recently reveal that the market considers a rate hike more likely than a rate cut. These differences are not statistically significant.

Eurodollar futures provide a measure of expected monetary policy over a longer time horizon—out several years. These yields also include premiums related to various risks beyond those faced in the federal funds market. As a result, they also tend to overpredict the fed funds rate and, as in all forecasts, the bias tends to increase as the horizon recedes. Near-term Eurodollar futures suggest that after the current "pause," fed funds rates will dip through 2007 and start to rebound in 2008. The difference between Eurodollar futures on September 21 and October 13 suggests that the likelihood of any policy "reversal" has lessened.

Changes in the yield curve mirrored those in Eurodollar futures. On September 22, the yield on the one-year Treasury bill was 4.97%; by October 13, it had risen to 5.01%. The yield curve currently is inverted.

Historically, an inverted yield curve has often foretold a recession. But the relationship between the yield curve and economic activity has changed in recent years, largely because the FOMC has been able to contain inflationary pressures. Transitory inflationary pressures no longer have a substantial effect on long-term inflation expectations (and hence bond rates). Transitory inflationary shocks, however, continue to boost short-term rates as the FOMC acts to contain inflation; consequently, the yield curve inversion is now seen as the result of a stable non-inflationary policy, not the go-stop policies associated with earlier periods.