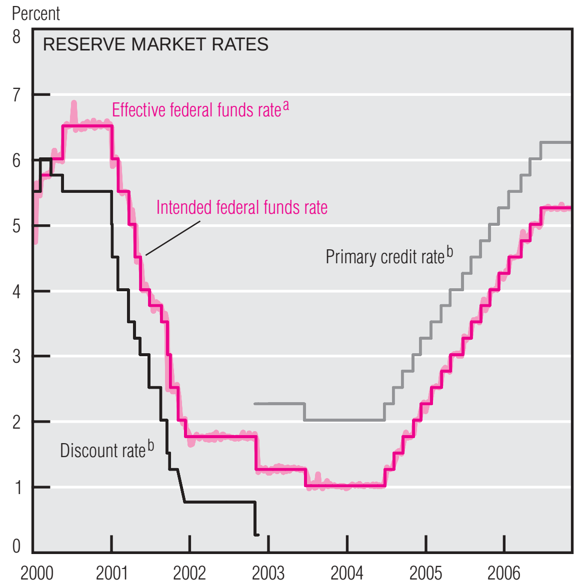
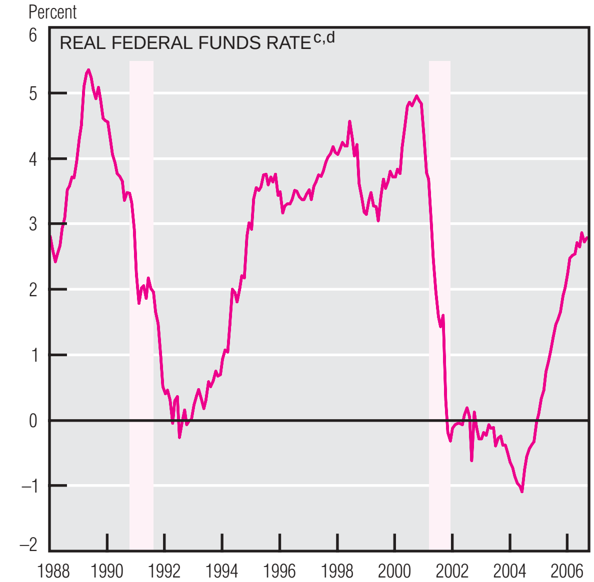
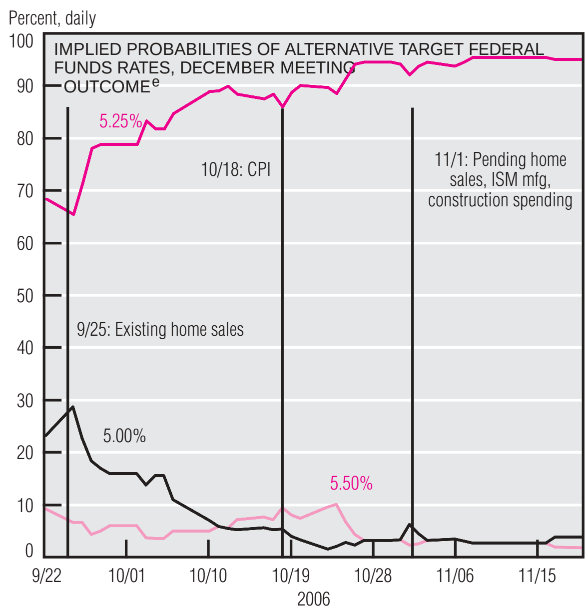
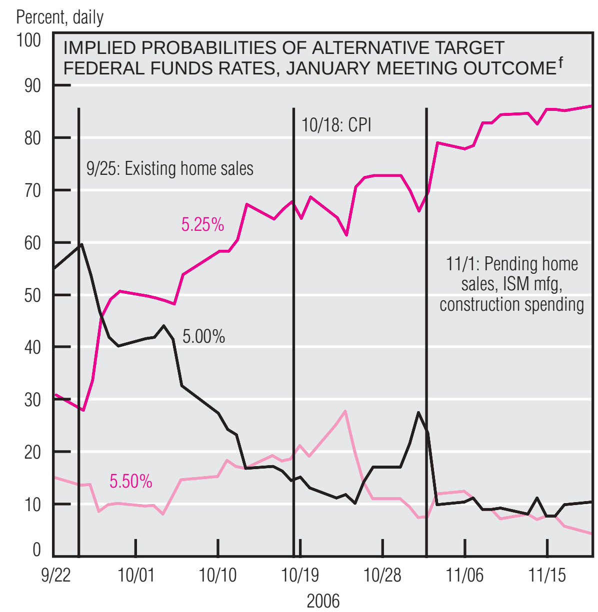
# Monetary Policy




a. Weekly average of daily figures.
b. Daily observations.
c. Defined as the effective federal funds rate deflated by the core PCE.
d. Shaded bars represent periods of recession.
e. Probabilities are calculated using trading-day closing prices from options on December 2006 federal funds futures that trade on the Chicago Board of Trade.
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; the Chicago Board of Trade; and Institute for Supply Management.

At its October 25 meeting, the Federal Open Market Committee left the target federal funds rate unchanged at 5.25% for the third consecutive time. Likewise, the Board of Governors left the primary credit rate at 6.25%. The press release that followed the Committee's meeting stated, "Going forward, the economy seems likely to expand at a moderate pace," but added, "Nonetheless, the Committee judges that some inflation risks remain." The next meeting is scheduled for December 12.

The real federal funds rate—defined as the effective federal funds rate less core inflation in personal consumption expenditures (PCE)—has shown signs of leveling off and now stands at 2.76%. Holding the effective funds rate constant since the last meeting, the real funds rate has gained 6 basis points because core PCE inflation has slowed slightly.

Participants in the federal funds futures and options market believe that a continued pause is almost assured. As of November 20, the implied probability of the federal funds target rate remaining at 5.25% stood at 95% for December. The probability that this will carry over to the January meeting was down only 10%, to 85%. It is can be very hard to gauge the impact of data releases: The September release on existing home sales came in 1.1% below consensus expectations, with the median price down 2.2% on a year-over-year basis. Market participants may have perceived this as increasing the likelihood of a "hard landing" in the housing market,

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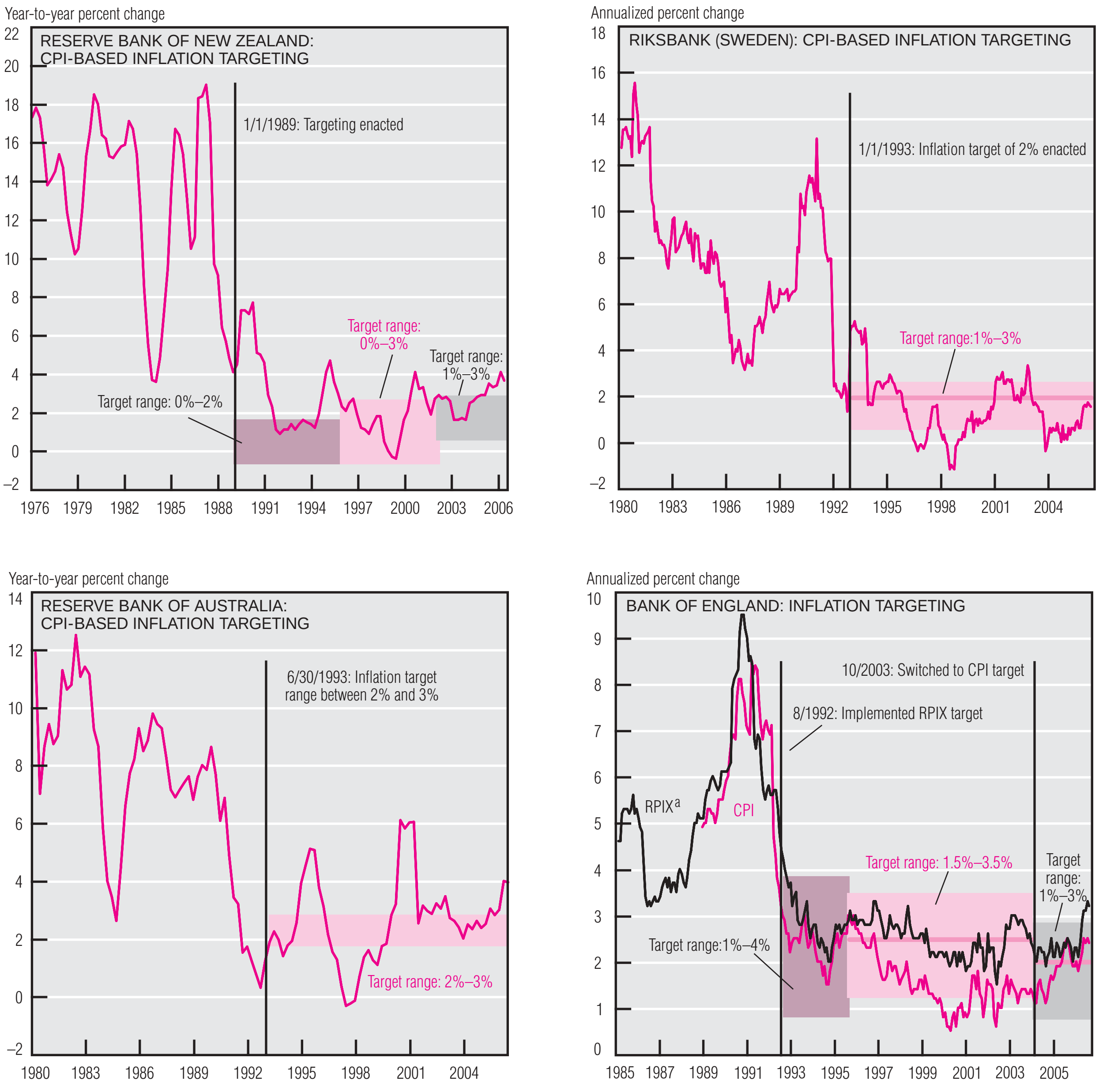
# Monetary Policy *(cont.)*




a. RPIX is the Retail Price Index excluding mortgage interest payments.
SOURCES: Reserve Bank of New Zealand; Riksbank, *Statistics Sweden*; Reserve Bank of Australia; and Bank of England, *Statistics England*.

thereby increasing the implied likelihood of a future cut in the fed funds target. However, that perception was short lived, and probabilities started to rebound the very next day.

When evaluating current U.S. monetary policy, it is useful to look at how other countries' central banks are working to enhance credibility in an effort to keep inflation low. Many countries use inflation targeting as a means of gaining credibility. In 1989, the Reserve Bank of New Zealand became the first central bank to adopt a formal inflation target and was quickly followed by Canada, England, Sweden, Australia, and others.

Countries have employed a variety of methods for promoting price stability. Some countries favor an explicit target versus a target range when trying to achieve stable prices. Sweden and England, for example, use an explicit target (currently 2%), whereas New Zealand and Australia prefer to target a range of inflation (currently 1%–3% and 2%–3%, respectively). Even with an explicit target, the Bank of England will act only if it misses the target by more than 1 percentage point on either side; in that case, "the Governor of the Bank of England must write an open letter to the Chancellor explaining the reasons why inflation has increased or fallen to such an extent and what the Bank proposes to do to ensure inflation comes back to the target."

How important are these countries' formal targets for lowering inflation and keeping it low? Each of them had substantial disinflation even before they began inflation targeting; afterward, targeting may have enhanced their ability to keep inflation low. Although a country can theoretically change its inflation target every year, in practice targets change very little. For example, New Zealand has changed its target only three times since 1989, from a low of 0%–2% to the current high of 1%–3%.