

The Economy in Perspective

When to say when... The Federal Open Market Committee increased its federal funds rate target by 25 basis points, to 3.25%, at its June 30 meeting. That action, which was widely anticipated by financial market observers, was the latest manifestation of the “measured pace” policy that the Committee announced a year ago. As long as the federal funds rate target was moving from 1% to 3%, few analysts expected the measured pace to slow or stop, but now that the target lies above 3%, some analysts think that the FOMC is approaching a resting point in its policy-tightening cycle.

The short end of the Treasury yield curve is pegged near the funds rate target, and futures markets indicate that short-term rates are headed toward 4% by the end of the year, where interest rates now sit at the 10-year segment of the yield curve. For nearly its entire length, the yield curve’s implied one-year-forward rate is 4% (that is, the implied one-year rate between any two adjacent years from two years ahead through 29 years from now is about the same: 4%).

This flatness in the yield curve reflects financial markets’ current belief that the FOMC funds rate target is likely to lie somewhere between 25 and 100 basis points away from a resting place. Right now, options on fed funds futures contracts imply a funds rate in October of 3.75% with a roughly 70% probability. The odds might change as economic data and opinions about how to interpret them evolve. For example, in the spring of 2004, not only was the Treasury yield curve much steeper than it is today (short-term interest rates were much lower then), but the 10-year rate was also expected to climb toward 5%, rather than 4%. Last June, the one-year-forward rate seven years out was approximately 6%, rather than 4%.

What could make market participants alter their views of the economy and monetary policy? Oil prices are one possible factor. Earlier in the expansion, when oil prices initially surged, forecasters worried that the price shock could seriously retard—or even derail—economic recovery. These concerns faded as consumers and businesses maintained their spending through both the initial shock and a subsequent jolt that propelled oil prices above \$50 per barrel. Now that prices have breached the \$60 per barrel mark, it seems that analysts might have become too blasé.

Energy price shocks present complications for monetary policy makers because they can simultaneously slow the pace of growth and raise measured inflation rates. Because it is often difficult to expand the supply of energy and certain other natural resources quickly, their prices rise steeply in the face of strong demand or shortfalls in supply. Unquestionably, continual energy and commodity price hikes have accelerated inflation during the past few years. In theory, price shocks’ effect on inflation should dissipate over time; indeed, this phenomenon could explain why longer-term inflation expectations and interest rates seem so stable, even though core inflation has been creeping up for a few years.

The FOMC has no official inflation target, so it is not possible to refer to a specific benchmark in assessing monetary policy. Nevertheless, several FOMC members have indicated their preference for CPI-based inflation to fluctuate in a range from 1% to 3%. Such a range allows for transitory periods of unusually large price shocks in either direction, among other contingencies. Consequently, one might expect these FOMC members to be comfortable with CPI-based inflation averaging roughly 2% over longer periods of time. During the past 12 months, CPI inflation has increased by 2.8%, and core measures of inflation have been rising at rates nearer 2¹/₄% to 2¹/₂%, a pace that could become uncomfortable if the inflationary pressures seemed poised to intensify rather than unwind over the next year or so.

Common gauges of monetary policy are not precise enough to calibrate the stance of policy on their own. One measure, the Taylor rule (using the version reported on regularly by the Federal Reserve Bank of St. Louis), suggests that monetary policy has finally removed enough accommodation to be compatible with an inflation goal of 4%. Another measure, McCallum’s rule (also as reported by the St. Louis Fed), suggests that the monetary base has been growing at a rate that is compatible with a 0% inflation goal. Implementing these rules requires various judgments, and different versions of the rules—including one showing that current policy is compatible with an inflation goal in the middle of the 1%–3% range—will yield different views on when to say when.