On August 10, the Federal Open Market Committee raised the federal funds rate target to 1.50%, 25 basis points (bp) higher than the target established on June 30. Concurrently, the Board of Governors raised the discount rate 25 bp to 2.5%. These moves are expected to be the first of several: The federal funds futures market indicates that market participants expect the funds rate to exceed 2% by early 2005.

Much of the discussion about where rates will go centers around the FOMC’s statement that “policy accommodation can be removed at a pace that is likely to be measured.” The impetus to remove accommodation is made apparent by looking at the Taylor rule, a popular benchmark for the fed funds rate which posits that the FOMC balances its response between economic growth and inflation. The form of the Taylor rule depends on the weights given to inflation and output, and to the assumed inflation target; but since mid-2002, the rate has stayed below the rule’s prediction, even assuming a rather high inflation target of 4%.

The implications of removing accommodation at a “measured” pace become clearer in comparison with the two previous cycles of rate increases. The 1999 cycle increased rates by 175 bp in less than a year, with only one jump of more than 25 bp. The 1994 cycle was both faster and longer, with a 300 bp increase, including a jump of 75 bp in November 1994.