At its most recent meeting, held on September 21, the Federal Open Market Committee (FOMC) raised the target federal funds rate 25 basis points (bp) to 1.75%, the third such increase since the record low of 1.00% was reached in June 2003. Many Federal Reserve officials have publicly stated that the federal funds rate remains accommodative. Market participants anticipate that the federal funds rate will rise; however, the timing and magnitude of the increase are uncertain.

Federal funds futures contracts are one tool for gauging short-term policy expectations. Expectations of policy changes have remained relatively stable since August, and market participants currently expect a further increase of at least 50 bp over the next six months. However, since the FOMC began to raise rates at the June 29–30 meeting, market participants have postponed their expectations of subsequent increases in the federal funds rate and have revised expectations down about 50 bp since mid-June. Market participants now expect the rate to be roughly 2.0% by the end of 2004. The federal funds options market allows calculation of the probabilities associated with various federal funds rate changes. It indicates that market participants place a probability of nearly 90% on a 25 bp increase in the federal funds rate at the November 10 meeting. This suggests that participants anticipate a pause in rate hikes in December.

Eurodollar futures, often used to gauge long-term policy expectations, reveal a similar pattern: While longer-term expectations have declined since the beginning of the latest round of federal funds rate increases, they have recently stabilized.

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The yield curve has shifted downward across the intermediate- and long-term maturities since the Federal Open Market Committee began the current round of federal funds rate increases. The yields on both the 10- and 20-year maturities fell about 60 bp. Some suggest that the flattening of the yield curve reflects the lower real rate of return on capital resulting from rising energy costs. Others argue that despite rapidly rising energy prices, the flatter yield curve reflects lower long-term inflation expectations. This suggests that the Federal Reserve’s price stabilization policy has credibility—participants believe the Fed will not allow inflation to accelerate in response to the energy price shocks.

Anchoring inflation expectations is a crucial component in stabilizing prices. Some countries have established explicit inflation targets to help achieve and maintain price stability. For example, Canada, Sweden, and New Zealand set inflation target ranges of 1.0% to 3.0% (as measured by each country’s consumer price index) in the early 1990s. The range of growth in consumer prices throughout these countries has declined over the past decade.

However, some analysts argue that a central bank needn’t explicitly define an inflation target if it can gain credibility for maintaining low and stable inflation, thereby anchoring inflation expectations. Indeed, U.S. households have significantly reduced the range in which their short-term and long-term inflation expectations have varied since the 1970s: Short-term expectations have ranged between roughly 2.5% and 4.0% over the past decade, while long-term expectations have ranged between 3.0% and 4.0%.