At its May 3 meeting, the Federal Open Market Committee (FOMC) raised its federal funds rate target from 2.75% to 3%—about 1 percentage point above the core inflation rate of personal consumption expenditures over the past year. This increase was widely anticipated.

The move was consistent with the FOMC’s recent actions and the forward-looking language of its policy statements. For about a year, they have said, “the Committee believes that policy accommodation can be removed at a measured pace.” When the real (inflation-adjusted) fed funds rate was hovering near zero, it was widely understood that sustaining such a policy would ultimately induce inflationary pressures.

When the economy gained traction in the spring of 2004, the question facing policymakers became not whether rates would increase, but how much. Containing inflation expectations has allowed for an attenuated increase in the funds rate compared to past economic recoveries. But market participants understand that the funds rate eventually will approach a level consistent with a more neutral policy stance. Much attention has thus been given to both the statement language and the meeting minutes, which are now released three weeks after the meeting, for hints as to a change in the pace of rate hikes.

When the May 3 minutes were made public on May 24, they did not cause much surprise; asset prices moved very little. Markets know that

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Monetary Policy (cont.)

Policymakers face increased uncertainty about the direction of inflation and the strength of the economy; nonetheless, they trust that the FOMC will “respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.”

Implied yields derived from federal funds futures have been relatively good predictors of near-term policy actions. Over the winter months, yields suggested that the requisite policy response for maintaining price stability would include at least one rate hike of 50 basis points (bp) before the end of summer. Since the beginning of spring, however, the expected trajectory of near-term hikes in the fed funds rate has flattened, and the probability of a 50 bp rate hike at the June meeting, recovered from options on fed funds futures, is now less than 10%.

Implied yields that are derived from eurodollar futures provide some measure of expected policy actions over longer horizons. These yields tend to overpredict the fed funds rate, especially in the out years, and thus need to be adjusted for term premiums. Changes in the trajectory of the implied yields also indicate changing policy predictions. They reveal a substantial retrenchment in the expected fed funds rate two years and more in the future. A similar change has occurred in the term structure of interest rates: Short-term rates have risen, whereas longer-term rates have stabilized at relatively low levels.