On September 20, the Federal Open Market Committee (FOMC) increased the intended federal funds rate 25 basis points (bp) to 3.75%, the eleventh such increase since the current round of tightening began in late June 2004. The FOMC’s press release stated that before Hurricane Katrina, “output appeared poised to continue to grow at a good pace.” However, it noted, the storm’s economic consequences would “imply that spending, production, and employment will be set back in the near term.” Nonetheless, the FOMC maintains the position that accommodation can continue to be “removed at a pace that is likely to be measured.”

The 25 bp hike in the funds rate did not surprise participants in the federal funds options market. The day before the September meeting, they placed an 82% probability on such a hike. But in the last three weeks, as the extent of Katrina’s damage has become clear, their view of policy’s future course has changed substantially. On August 29, implied yields placed an 84% probability that the federal funds rate would be raised to 4% at the November meeting; during the first week of September, they thought it most likely that November would bring a pause in policy tightening.

However, the September 16 release of the University of Michigan’s consumer sentiment survey reported a major jump in inflation expectations, shifting participants’ views away from a pause in November and toward a rate increase. They now place a 75% probability on another 25 bp hike, and fed funds futures also indicate more hikes to come this year.