At its November 1 meeting, the Federal Open Market Committee (FOMC) raised its federal funds rate target from 3.75% to 4%, which is still less than 2 percentage points above the core inflation rate of personal consumption expenditures for the past year. The rate hike was widely anticipated.

Because the most recent annual core inflation rate is often viewed as a proxy for expected future inflation, the difference between the fed funds rate and core inflation rate is commonly used to measure the real (inflation-adjusted) fed funds rate. However, in light of hurricane-related inflation concerns, trailing core inflation might be a questionable proxy for inflation expectations. Indeed, the inflation expectations revealed in other, more prospective, measures—such as those from survey data or market yields on inflation-protected securities—are currently higher than recent inflation levels. Hence, a real fed funds rate based on trailing inflation may be an overestimate. This would suggest that a greater degree of policy accommodation remains.

The November policy move was consistent with the forward-looking language offered in recent statements. For more than a year now, the FOMC policy statement has repeated that “the Committee believes that policy accommodation can be removed at a measured pace.” The fed funds rate (continued on next page)
Monetary Policy (cont.)

has risen in increments of 25 basis points at each FOMC meeting without
a hint of when a pause might occur.
The minutes of the November
meeting, released with a three-week
lag, seemed to make preparations
for removing the “measured pace”
language. Analysts focused on this
sentence: “Several aspects of the state-
ment language would have to be
changed before long, particularly
those related to the characterization
and outlook for policy.” However,
prices of fed funds futures and
options on those futures suggest that
market participants do not expect
dramatic changes in the language.
Rather, a pause in rate hikes some-
time next spring had already been
priced into these instruments.
Implied yields based on the prices
of fed funds futures indicate that the
funds rate is expected to rise to
between 4.5% and 4.75% by April.
Moreover, options on these futures
suggest that rate hikes of 25 basis
points each at the December and Jan-
uary meetings remain very likely.
Thus the release of the minutes
seemed to have only a marginal
effect on when market participants
expected a pause. After the minutes
were released, investors were giving
slightly higher odds that the pause
would be announced at the March
meeting.
Yields on Treasury bonds tended
to fall after the release, but only mar-
ginally. On the whole, financial mar-
kets seem fairly confident that hurri-
cane-related inflation concerns will
come to pass, and that policy may be
approaching a more neutral setting.

a. One day after the FOMC meeting.
b. All yields are from constant-maturity series.
c. Average for the week ending on the date shown.
d. First weekly average available after the FOMC meeting.