



The FOMC's "Considerable Period"

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At its August 12, 2003, meeting, the Federal Open Market Committee (FOMC) took the unusual step of foreshadowing its future policy course by announcing that its current highly accommodative monetary policy could "be maintained for a considerable period." Although the FOMC did not specify the length of the "considerable period," the change in federal funds rate futures contracts suggested that market observers interpreted the language to be a commitment by the FOMC that it would not increase its target level of the federal funds rate for at least six months, perhaps longer. The FOMC repeated this language in the press releases following its subsequent three meetings.

The FOMC's August minutes note that they made this unconventional policy commitment, with the federal funds target rate already at the "quite accommodative" level of 1 percent, "to encourage progress toward closing the economy's currently wide output gap and, with inflation already near the low end of what some members regarded as an acceptable range, to resist significant further disinflation." Because spending decisions are more closely linked to the behavior of longer-term rates, to achieve this goal the FOMC appears to have made this unconventional commitment so as to reduce long-term interest rates in the absence of further reductions in the federal funds rate target.

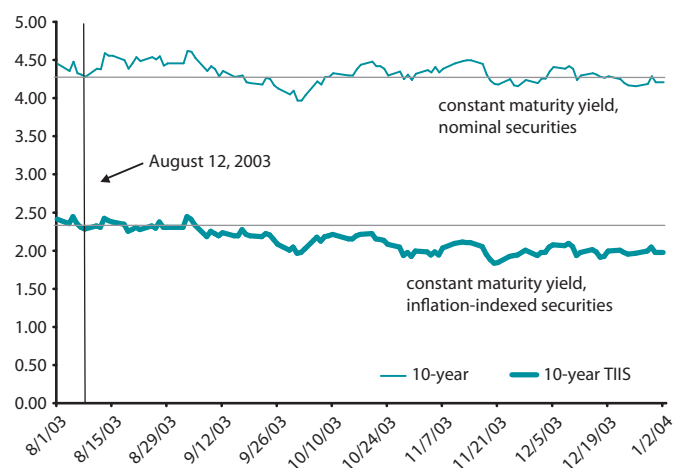
Even if longer-term rates are determined in large part by market expectations for future short-term rates, it is difficult to know how changes in monetary policy will affect longer-term nominal interest rates. The effect of monetary policy on longer-term rates is complicated by the fact that observed long-term nominal rates comprise three unobserved components—the real rate, the inflation compensation, and a premium for inflation uncertainty. Consequently, longer-term rates need not fall when monetary policy eases, whether the easier policy comes in the form of a reduction in the overnight rate target or by an unconventional commitment to extend the duration of a low target rate for a time period longer than suggested by historical experience.

While an apparently easier policy might reduce one component, such as the real rate, it might simultaneously increase the level of or uncertainty associated with expectations of future inflation. For example, despite widely publicized

decreases in actual inflation, longer-term nominal rates have decreased by substantially less, since January 2001, than the FOMC's 550-basis-point reduction in the federal funds rate.

Economists often look at the market for inflation-indexed government bonds when they seek to separate changes in longer-term nominal rates into their real and expected inflation components. The figure tracks the 10-year constant-maturity yields on Treasury nominal and inflation-indexed securities since the August publication of the "considerable period" language. The generally downward drift of the TIIS yield suggests that the FOMC's unconventional language might, in fact, have reduced real long-term interest rates. At the same time, the essentially unchanged nominal 10-year yield suggests that the decrease in the real-rate component has been matched by either an increase in inflation compensation or the inflation-uncertainty premium. It remains an open question whether this unconventional policy will cause the output gap to close more quickly. ■

10-Year Constant-Maturity Treasury Yields Since August 1, 2003



SOURCE: Board of Governors of the Federal Reserve System, H.15 release, daily figures.