



INSIDE THE VAULT | SPRING 2001

<https://www.stlouisfed.org/publications/inside-the-vault/spring-2001/reading-the-feds-playbook>

Reading the Fed's Playbook

In an athletic competition, one team attempts to "read" the upcoming plays of the other team. In fact, it's probably fair to say that the athlete's ability to read the next move of an opponent gives him or her a distinct advantage in deciding what actions to take. Similarly, the financial community and the public at large keep a close watch on the Fed and attempt to read the Fed's monetary policy actions. Unlike a competing team, however, the Fed has taken steps to provide signals which are more easily understandable for economic spectators.

From the Broadcast Booth

In February 1994, the Fed began the practice of announcing changes in its target for the federal funds rate immediately after making them. Furthermore, in 2000, the Federal Open Market Committee (FOMC) began issuing an accompanying statement indicating whether it viewed impending economic risks as inflationary, balanced or tending toward a weakening economy. For example, after its December 2000 meeting, the FOMC announced that it changed its balance of risk statement from "The risks are weighted mainly toward conditions that may generate heightened inflation" to "The risks are weighted mainly toward conditions that may generate economic weakness." This announcement policy provides a signal that is immediately communicated to the public and draws a quick reaction from the financial community.

On the Game Schedule

Also beginning in 1994, the FOMC started the practice of announcing its policy decision. In addition, since then it has followed the practice of making changes in the federal funds rate target primarily at regularly scheduled meetings. Since February 1994, 19 of the 23 changes in the federal funds rate target have been made at regularly scheduled FOMC meetings. Prior to this, however, changes in the target were often made between regularly scheduled meetings. For example, of the 55 changes in the federal funds rate target between 1987 and 1994, only seven occurred at regularly scheduled meetings of the FOMC, and 48 were made during intermeeting periods. An addition—though perhaps less obvious—procedural change also occurred in 1994. Previously, the Chairman frequently exercised his discretion to adjust the federal funds rate target during intermeeting periods without formally consulting with other members of the FOMC. In fact, all 48 intermeeting target changes made during the '87 to '94 period were made at the Chairman's discretion. Current practice for making intermeeting adjustments to the intended federal funds rate suggests that "the Chairman, if feasible, will consult with the Committee before making any adjustments."¹ Although the Chairman of the FOMC is authorized "to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate," clearly the intent of this policy suggests that the Chairman will consult with the committee before changing the target.² It is not surprising that all four of the target changes made since 1994 that did not occur at regularly scheduled meetings followed a teleconference.

With the "Basis" Loaded

In order to correctly forecast Fed actions, the markets must forecast both the magnitude and timing of changes in the funds rate target. Since late 1989, the Fed has changed the funds rate target by multiples of 25 basis points, or 1/4 of a percent.

Of the 44 changes in the intended funds rate since October 1989, all but one (the 75 basis-point increase on Nov. 15, 1994) have been either 25 or 50 basis points.

By changing its announcement policy, making decisions primarily at regularly scheduled meetings and maintaining consistency in the magnitude of funds rate target changes, the FOMC has made the "Fed playbook" easier to read. So the next time you want to know what the Fed is doing, take a look at the playbook.

The Federal Funds Rate

The Fed's primary mission is to ensure that enough money and credit are available to sustain economic growth without inflation. The Fed's primary monetary policy tool is open market operations, which is the buying and selling of U.S. government securities on the open market for the purpose of influencing short-term interest rates and the growth of money and credit. The effect of the Fed's purchases or sales of government securities is a decrease or increase in reserves of financial institutions. This change in the supply of reserves affects the federal funds rate, the interest rate that depository institutions charge other depository institutions for short-term lending. Therefore, although the Fed does not directly control the federal funds rate, the Federal Open Market Committee makes changes in monetary policy by targeting the rate and engaging in open market operations to achieve this target.

Have You Ever Wondered ...

- *how the Fed fights inflation?*
- *where a check goes after you write it?*
- *how the Fed creates money?*
- *what bank examiners look for?*

You'll find the answers to these questions and more in an upcoming web site called FED101. Within this virtual classroom, you will find fascinating facts about the history and structure of the Federal Reserve System, get in on interviews with Fed presidents or click through interactive simulations. Look for the announcement of FED101 in early June on our Bank's web site at www.stls.frb.org/education.

This article was adapted from "The Codification of an FOMC Procedure" and "What Accounts for the Reduced Frequency of Fed Actions?" which were written by Daniel L. Thornton and appeared in the March and April 2001 issues of Monetary Trends, a St. Louis Fed publication.

Endnotes

1. Federal Reserve Bulletin (May 2000), p. 330. [back to text]

2. Ibid. [back to text]



INSIDE THE VAULT | SPRING 2001

<https://www.stlouisfed.org/publications/inside-the-vault/spring-2001/q--a>

Q & A

What's a yield curve?

Bonds with identical risk, liquidity and tax characteristics usually have different interest rates because of different times remaining to maturity. A yield curve is a picture contrasting yields with time to maturity for similar bonds. Yield curves usually slope upward because bonds with longer time to maturity usually pay higher interest rates.

Why are higher yields associated with bonds that have a longer maturity?

A longer-term bond involves more risk from interest rate fluctuations. Also, the longer-term bond encompasses expected inflation over the life of the bond. You may recall that nominal interest rates equal the real interest rate plus expected inflation. For example, if the real interest rate is 2.5% and expected inflation is 2%, the nominal interest rate would be 4.5%. Longer-term bonds require compensation for this inflation risk.

Why do long-term interest rates sometimes rise when the Fed cuts the federal funds target, causing short-term interest rates to fall?

Although the Fed can exert considerable influence over short-term rates, changes in inflation expectations can confound the effect of the federal funds target changes on longer-term rates. Easier monetary policy lowers short-term rates now, often at the expense of higher prices in the future.

What causes the yield curve to be inverted?

Although the yield curve is often upward sloping, sometimes it is downward sloping, in which case it is referred to as inverted. In this case, short-term interest rates are higher than long-term interest rates. If financial markets expect a weakening economy, long-term rates may fall relative to short-term rates. Although an inverted yield curve doesn't always signal a recession, it does indicate the markets' future expectations regarding the direction of the economy's performance.

The content for Q & A was adapted from "The Long and the Short of the Federal Funds Target Cuts," which was written by Michael T. Owyang, economist at the Federal Reserve Bank of St. Louis, and appeared in the September 2001 issue of Monetary Trends, a St. Louis Fed publication.



FEDERAL RESERVE BANK *of* ST. LOUIS
CENTRAL TO AMERICA'S ECONOMY®

INSIDE THE VAULT | SPRING 2001

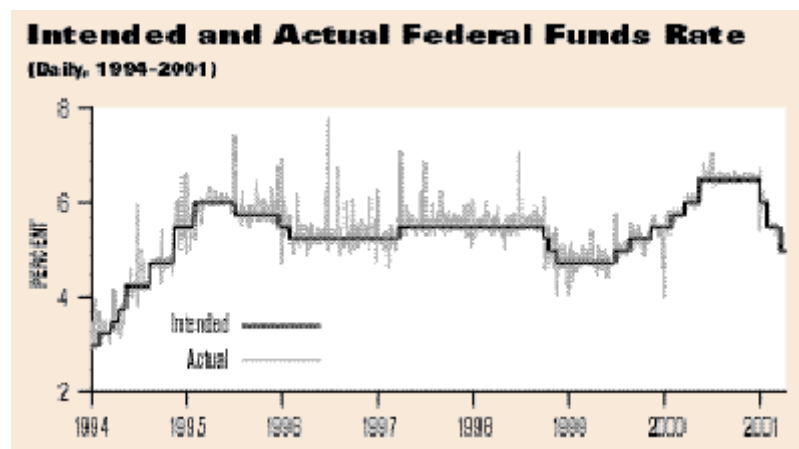
<https://www.stlouisfed.org/publications/inside-the-vault/spring-2001/economic-snapshot>

Economic Snapshot

1st Quarter 2001

	Q2-00	Q3-00	Q4-00	Q1-01
Growth Rate—Real Gross Domestic Product	5.6%	2.2%	1.0%	NA*
Inflation Rate—Consumer Price Index	3.0%	3.5%	2.9%	4.2%
Civilian Unemployment Rate	4.0%	4.0%	4.0%	4.2%

*Not available



From Board of Governors, Federal Reserve Systems, through April 13, 2001, adapted by Michael Pakko, economist at the Federal Reserve Bank of St. Louis

Why does the federal funds target rate change?

The goal of the Fed is to promote economic growth without inflation. Economic conditions that indicate inflationary pressures call for the Fed to tighten monetary policy by raising the federal funds target rate. Conversely, when economic weakness appears, the Fed lowers the federal funds target rate in order to encourage economic growth.

Why is there often a difference between the targeted federal funds rate and the actual rate?

Although the Fed has a high degree of influence on the supply of Bank reserves, there are fluctuations and uncertainties on the demand side of the reserves market. For example, in the graph above, when overall demand for reserves was higher than the Fed anticipated, banks bid up the price of those funds, boosting the actual funds rate higher than the target rate.