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On June 30, the Federal Open Market Committee (FOMC) raised the target for its key federal funds rate by 25 basis points after holding it at 1 percent for over a year. Such policy actions are commonly called "tighter" monetary policy. The Committee was in a similar situation in early 1994. Then, as now, relatively slow employment growth following a recession had led the Committee to keep its target federal funds rate constant at a low level for more than a year. The chart shows the Committee's federal funds rate target from one year before the tightening began until one year after. In the 1994 episode the federal funds rate target moved 300 basis points in one year. The 2004 episode has yet to unfold, but the federal funds futures data plotted in the figure suggest a substantial tightening of policy is in the offing.

The level of the federal funds rate is substantially lower today than it was at the beginning of the 1994 episode. This could be due to differing inflation levels. However, the core personal consumption expenditures inflation rate from a year earlier was 2.1 percent in January 1994, versus 1.6 percent in May 2004, a difference of just 50 basis points. Thus, differences in inflation levels alone cannot account for the 200 basis point difference in the federal funds rate at the onset of tightening in the two episodes. One interpretation is that the federal funds target is somewhat lower today relative to inflation than it was at the beginning of 1994, and that the FOMC may have further to go today to return the rate to a neutral level.

One simple rule of thumb for a neutral rate adds trend productivity growth, trend labor force growth, and a long-run target inflation rate together to yield a target federal funds rate consistent with the economy's long-run growth potential and the FOMC's inflation goal. Many analysts assign 1.0 percent for long-run labor force growth. In 1994, 3.0 percent might have been a reasonable assumption for an inflation target, whereas today 2.0 percent might be a better guess. Trends in productivity growth are harder to discern.

During the early 1990s, trend growth in nonfarm business sector productivity was often assumed to be about 1.5 percent. The three figures (1.0 + 3.0 + 1.5) then sum to 5.5 percent, and the 1994 tightening episode indeed ended with the federal funds rate just over that level, at 6.0 percent, in early 1995. But since 1994, trend productivity growth has increased. In fact, recent nonfarm business sector productivity growth has been shockingly robust: 4.9 percent in 2002 and 4.4 percent in 2003. Even if the underlying long-run trend is only 2.5 percent, that still suggests a sum (1.0 + 2.0 + 2.5) yielding a neutral federal funds rate of 5.5 percent, just as in 1994. But today the federal funds target is 425 basis points below that level. Because the FOMC is starting from a relatively low target level, and because the neutral level is at least as large as it was in 1994, this rule of thumb suggests that the Committee may have a long way to go. ■

1994 vs. 2004