

Meeting of the Federal Open Market Committee March 18, 2003 Presentation Materials -- Text Version

[Presentation Materials \(1.27 MB PDF\)](#)

Pages 91 to 101 of the Transcript

Appendix 1: Materials used by Mr. Kos

Page 1

Top panel

Title: Current 3-Month Deposit Rates and Rates Implied by Traded Forward Rate Agreements

Series: U.S. and Euro Area LIBOR fixings, U.S. and Euro Area 3-, 6-, and 9- Month Forward Rate Agreements

Horizon: December 2, 2002 - March 17, 2003

Description: Three-month Libor fixings and rates implied by traded forward rate agreements declined modestly during the intermeeting period.

Bottom panel

Title: Japanese Government Yield Curves

Series: Japanese Sovereign Debt Yield Curve as of 3/18/2002 and 3/17/2003

Horizon: March 18, 2002 and March 17, 2003

Description: Japanese sovereign debt yield curve flattens in 2003 compared with the same time in 2002.

Page 2

Top-left panel

Title: 2-Year Swap Rates and Policy Rates for Selected Currencies: U.S.

Series: 2-Year Swap Rate, Fed Funds Target Rate

Horizon: December 2, 2002 - March 17, 2003

Description: The two-year swap rate declines, while the fed funds target rate remains unchanged.

Top-right panel

Title: 2-Year Swap Rates and Policy Rates for Selected Currencies: Euro-Area

Series: 2-Year Swap Rate, ECB Minimum Refinancing Bid Rate

Horizon: December 2, 2002 - March 17, 2003

Description: The two-year swap rate and the ECB minimum refinancing bid rate decline.

Middle-left panel

Title: 2-Year Swap Rates and Policy Rates for Selected Currencies: U.K.

Series: 2-Year U.S. Swap Rate, BoE Repo Rate

Horizon: December 2, 2002 - March 17, 2003

Description: The two-year swap rate and the BoE repo rate decline.

Middle-right panel

Title: 2-Year Swap Rates and Policy Rates for Selected Currencies: Australia

Series: 2-Year U.S. Swap Rate, RBA Cash Target Rate

Horizon: December 2, 2002 - March 17, 2003

Description: The two-year swap rate declines, while the RBA cash target rate remains unchanged.

Bottom panel

Title: 2-Year Swap Rates and Policy Rates for Selected Currencies: Canada

Series: 2-Year U.S. Swap Rate, BoC Bank Rate

Horizon: December 2, 2002 - March 17, 2003

Description: The two-year swap rate and BoC bank rate increase.

Page 3

Top panel

Title: Euro-Dollar Exchange Rate

Series: Euro-USD

Horizon: December 2, 2002 - March 17, 2003

Description: Since the last FOMC meeting, the dollar is relatively unchanged against the euro.

Middle panel

Title: Dollar-Yen Exchange Rate

Series: USD-Yen.

Horizon: December 2, 2002 - March 17, 2003

Description: Since the last FOMC meeting, the dollar is relatively unchanged against the yen.

Bottom panel

Title: The Dollar Versus Other Foreign Currencies

Series: CAD-USD, GBP-USD, CHF-USD, AUD-USD, NZD-USD

Horizon: December 2, 2002 - March 17, 2003

Description: Since the last FOMC meeting, the U.S. dollar has appreciated against the British pound and Swiss franc, depreciated against the Canadian dollar, and remained relatively unchanged against the New Zealand dollar and Australian dollar.

Page 4

Top-left panel

Title: U.S. Investment Grade Corporate Option-Adjusted Spreads

Series: U.S. Investment Grade Corporate Option-Adjusted Spread

Horizon: September 3, 2002 - March 14, 2003

Description: The U.S. investment grade corporate option-adjusted spread has been narrowing since October 2002.

Source: Lehman Brothers

Top-right panel

Title: EMBI+ Sovereign Debt and U.S. High Yield Corporate Spreads

Series: EMBI+ Sovereign Debt Spread, U.S. High Yield Corporate Option-Adjusted Spread

Horizon: September 3, 2002 - March 14, 2003

Description: The EMBI+ sovereign debt spread and U.S. high yield corporate option-adjusted spread have been narrowing since October 2002.

Sources: Merrill Lynch, JP Morgan

Middle panel

Title: Short and Intermediate Swaption Volatility Indices

Series: Short and Intermediate Swaption Volatility Indices

Horizon: January 2, 2002 - March 14, 2003

Description: Short and Intermediate Swaption Volatility Indices have increased over the past year.

Source: Lehman Brothers

Bottom panel

Title: MBS Option-Adjusted Duration Versus 10-Year U.S. Treasury Yield

Series: 10-Year U.S. Treasury Yield, MBS Option-Adjusted Duration

Horizon: January 2, 2002 - March 14, 2003

Description: Ten-year Treasury yields and MBS option-adjusted duration have declined over the past year.

Source: Lehman Brothers (MBS)

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Top panel

Title: Outright Purchases for the System Open Market Account

Series: Total Monthly Outright Purchases for the System Open Market Account

Horizon: January 2002 - March 2003

Description: Total monthly outright purchases for the system open market account increased in February and March.

Appendix 2: Materials used by Mr. Reinhart

Chart 1

Policy Expectations

Chart 1 includes four panels that provide information on policy expectations.

Top panel

Expected Federal Funds Rates*

The line chart in the top panel shows the level of the expected federal funds rate on January 28, 2003 and March 18, 2003 at 10:00 AM and indicates that market prices now embed an anticipation that the funds rate will rise to about 3 percent in mid-2005.

* Estimates from federal funds and eurodollar futures with an allowance for term premia and other adjustments. [Return to text](#)

Middle-left panel

Expected Balance of Risks*

(Percent of Respondents)

	March	May	June
Weakness	63	58	56
Neutral	37	42	42
Inflation	0	0	2

* From March 14, 2003 Money Market Services survey. [Return to text](#)

Middle-right panel

Percent Expecting Balance Toward Weakness at March Meeting*

The line chart in the middle-right panel reveals that sentiment has shifted in recent weeks, with the share of investors anticipating the balance of risks tilted toward weakness at the March 2003 FOMC meeting rising from about 10 percent to nearly 65 percent.

* Responses from Money Market Services surveys. [Return to text](#)

Bottom panel

Implied Distribution of the Federal Funds Rate Derived from Options Prices*

The bottom panel is a bar-and-line chart showing the implied distribution of the federal funds rate derived from options prices six months ahead as observed on January 28, 2003 and March 17, 2003. The left tail of the probability distribution is now bunched at quite low levels of the funds rate and one-fifth of the mass rests above the current intended rate of 1¼ percent.

* Calculated from 150-day constant maturity eurodollar options. [Return to text](#)

Chart 2

Chart 2 includes two panels that provide information on the equilibrium real federal funds rate and long-run inflation expectations.

Top panel

The top panel depicts the actual real federal funds rate starting in the first quarter of 1990, together with market-based and staff estimates of the equilibrium real funds rate and a historical average calculated over the 1966-2002 period. The historical average is plotted as a horizontal line at 2.70 percent, while the actual real funds rate and the market-based estimate are plotted as declining lines. The staff estimates consist of a shaded region bound by the maximum and minimum values for each

quarter. The market-based estimate is currently at around 3 percent, while the staff estimates range between roughly 1 percent and -½ percent. Three points correspond to alternative values of the actual real funds rate based on three possible monetary policy decisions--i.e., no change in the target federal funds rate, a 25 basis point cut, and a 50 basis point cut.

Note: The shaded range represents the maximum and the minimum values each quarter of four estimates of the equilibrium real federal funds rate based on a statistical filter and the FRB/US model. Real federal funds rates employ four-quarter lagged core PCE inflation as a proxy for inflation expectations, with the staff projection used for 2003Q1.

Bottom panel
Long-Run Inflation Expectations

The line chart on the bottom panel conveys that, according to survey responses and market-based estimates, long-run inflation expectations continue to be stable. Survey expectations are from the Michigan survey and the Philadelphia Fed survey, while market-based expectations correspond to TIPS inflation compensation (the inflation rate that equalizes the price of the January 2012 TIPS and the value of a portfolio of nominal securities with the same payments).

Chart 3

Chart 3 presents six panels that summarize the current configuration of selected financial market quotes.

Top-left and top-right panels
Response of Two-Year Treasury, Response of Ten-Year Treasury, and Changes from 1/28/03 to 3/17/03

The two bar graphs in the top-left panel plot the daily changes in two- and ten-year Treasury yields since the January 2003 meeting; key data releases are also marked at February 7 (Employment Report), February 27 (Durable Goods), and March 7 (Employment Report). The bars span from about -5 to 5 basis points. Excluding the negative response to the March 7 employment report, two- and ten-year Treasury yields rose in the half-hour windows surrounding key data releases over the period. However, the table in the top-right panel, which displays the total changes in these yields and the changes attributable to the data releases, suggests that these reactions cannot account for the net movement in Treasury yields over the intermeeting period.

Changes from 1/28/03 to 3/17/03

	Due to Data Releases	Total
	-Basis Points-	
Two-Year	10	-5
Ten-Year	15	-16

Middle panels

The two middle panels consist of line charts of yields and spreads of selected private long-term debt.

Middle-left panel
Spreads of Selected Private Long-Term Yields

The middle-left panel includes yields on ten-year BBB-rated and AA-rated bonds, as well as yields

on ten-year swaps. The yields on BBB- and AA-rated bonds, which had moved within a relatively narrow range since the end of 2000, rose in the second half of last year to more than 300 basis points and nearly 150 basis points, respectively. Those yields have declined in recent months to about 225 basis points and 90 basis points, respectively. Ten-year swap yields have generally fallen since 2000, down about 75 basis points to roughly 50 basis points.

Note. Spreads measured over ten-year Treasury.

Middle-right panel High-Yield Debt Spreads

The middle-right panel depicts high-yield debt spreads for the telecom sector and the Master II index from Merrill Lynch. These spreads have also moved down significantly since October of last year.

Note: Spreads measured over ten-year Treasury. Source: Merrill Lynch.

Bottom panels

The bottom two panels present line charts of the implied volatilities of one-year swap rates and crude oil as of March 17, 2003 and the day before the preceding FOMC meeting, January 28, 2003.

Bottom-left panel One-year Swap Rate Implied Volatilities

The term structure of the swap rate implied volatility, shown in the panel for maturities between 3 months and 10 years, is downward sloping, ranging between 15 percent and 60 percent. The March 17 line is somewhat below the January 28 line for implied volatilities up to one year ahead.

Bottom-right panel Crude Oil Implied Volatility

The term structure of the crude oil implied volatility, shown in the panel for maturities between May 2003 and January 2004, is also downward sloping. The March line is well above the January line, ranging from about 70 percent to almost 30 percent.

Chart 4

Top-left panel Retain a Balanced Risks Assessment

- War worries will constitute a significant portion of the uncertainty.
- Economy is fundamentally sound.
- Change would convey more conviction to market participants than the committee actually had.

Top-right panel Shift to a Balance Weighted Toward Economic Weakness

- More weight given to:
 - Downbeat economic data of late.
 - Forecast that inflation would move lower from an already low level.
- Best matches investor expectations.

Middle panel

Frank Knight on Uncertainty

- ...we can only appeal to the law of large numbers to distribute the losses and make them calculable...in so far as they repeat themselves.
- ...The conception of an objectively measurable probability or chance is simply inapplicable.
- ...The fundamental uncertainties of economic life are the errors in predicting the future and in making present adjustments to fit future conditions.

Bottom panel

An Alternative Strategy

- Defer announcing an assessment of risks.
- Include a promise to the public of heightened surveillance.
- Be willing to convene a conference call before the next meeting if events offer some clarity of direction.

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