Meeting of the Federal Open Market Committee
August 10, 2004 Presentation Materials -- Text Version

Presentation Materials (2.59 MB PDF)

Pages 91 to 103 of the Transcript

Appendix 1: Materials used by Mr. Kos

Page 1

Top panel

Title: Current U.S. 3-Month Deposit Rates and Rates Implied by Traded Forward Rate Agreements
Series: 3-month USD Libor, USD 3-month forward rate agreement, USD 6-month forward rate agreement, USD 9-month forward rate agreement
Horizon: May 6, 2004 - August 6, 2004
Description: Forward rate agreements decrease slightly.

Middle-left panel

Title: Yield on the 2-Year Treasury Note
Series: Yield for the 2-year Treasury note
Horizon: May 6, 2004 - August 6, 2004
Description: Yield on 2-year Treasury note decreases sharply.

Middle-right panel

Title: Yield on the 10-Year Treasury Note
Series: Yield for the 10-year Treasury note
Horizon: May 6, 2004 - August 6, 2004
Description: Yield on 10-year Treasury note decreases sharply.

Bottom panel

Title: Yield Spread between 2- and 10-Year Treasury Notes
Series: Spread between the 2-year and 10-year Treasury note yields
Horizon: May 6, 2004 - August 6, 2004
Description: The Treasury yield curve widens modestly.

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Top-left panel

Title: Mortgage Market Duration

Series: Duration of 30-year MBS index
Horizon: May 6, 2004 - August 6, 2004
Description: Duration of 30-year MBS index falls sharply.

Source: Lehman Brothers

Top-right panel

Title: MBS Spreads
Series: OAS of 30-year MBS index
Horizon: May 6, 2004 - August 6, 2004
Description: OAS of 30-year MBS index narrows.

Source: Lehman Brothers

Middle-left panel

Title: Corporate Debt Spreads
Series: Investment grade corporate index OAS
Horizon: May 6, 2004 - August 6, 2004
Description: Investment grade corporate debt spread narrows.

Source: Lehman Brothers

Middle-right panel

Title: High Yield and EMBI+ Spreads
Series: EMBI Plus Index and high yield corporate debt index OAS
Horizon: May 6, 2004 - August 6, 2004
Description: EMBI+ spread narrows while high yield corporate debt spread widens.

Source: Merrill Lynch, JP Morgan

Bottom panel

Title: Select Equity Indices
Series: Dow Jones Industrials Index, NASDAQ Index, and the Standard & Poor's 500 Index
Horizon: May 6, 2004 - August 6, 2004
Description: U.S. equities decline.

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Top panel

Title: Current Euro-Area 3-Month Deposit Rates and Rates Implied by Traded Forward Rate Agreements
Series: 3-month Euro Libor, Euro 3-month forward rate agreement, Euro 6-month forward rate agreement, Euro 9-month forward rate agreement
Horizon: May 6, 2004 - August 6, 2004
Description: Euro forward rate agreements decrease.

Middle-left panel

Title: Euro-Dollar Exchange Rate

Series: Euro-dollar exchange rate
Horizon: May 6, 2004 - August 6, 2004
Description: Dollar depreciates against the euro.

Middle-right panel

Title: Dollar-Yen Exchange Rate
Series: Dollar-yen exchange rate
Horizon: May 6, 2004 - August 6, 2004
Description: Dollar depreciates against the yen.

Bottom-left panel

Title: 10-Year Japanese Government Bond Yield
Series: 10-year Japanese government bond yield
Horizon: May 6, 2004 - August 9, 2004
Description: Japanese 10-year government bond yield declines.

Bottom-right panel

Title: Japanese Equities
Series: Topix Index, Topix Banks Sub-Index
Horizon: May 6, 2004 - August 9, 2004
Description: Japanese equities decline.

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Top panel

Title: Implied Volatility on S&P 500 Index
Series: VIX index of implied volatility
Horizon: January 4, 1999 - August 6, 2004
Description: Implied volatility decreases.

Middle panel

Title: Implied Volatility of Major Currency Pairs
Series: 1-month dollar-yen implied volatility and 1-month implied volatility in euro-dollar
Horizon: January 4, 1999 - August 9, 2004
Description: Implied volatility in euro-dollar and dollar-yen declines.

Bottom panel

Title: Implied Swaption Volatility
Series: 1-month volatility on 10-year swaption and 1-month volatility on 2-year swaption
Horizon: May 3, 1999 - August 6, 2004
Description: Swaption volatility declines.

Appendix 2: Materials used by Mr. Gramlich

Figure 1
Output gap vs. real oil price

The period covered is from 1947 through 2004:Q2. The data are plotted on two curves. One curve represents the output gap and is plotted on the left axis. The data are expressed as a percent and represent nonfarm business; note that data are a staff judgmental estimate. The other curve represents composite refiner acquisition cost divided by GDP chain price index (2004:Q2 dollars per barrel). The curve is plotted on the right axis, and the data are expressed in 2004:Q2 dollars per barrel.

The output gap curve starts in 1960 at about negative 4 percent. It then climbs to just below 2 in 1961, drops to about negative 1 in 1962, and increases to about 0.25 in 1963. The curve continues downward to approximately negative 5.75 in 1966. The curve increases through 1968 to reach just above negative 4; it then decreases, fluctuating between about negative 4.75 and about negative 6.25 through the beginning of 1969. In 1970, the curve trends upward to reach about 1, then drops to about negative 2 in 1979. It then increases to about 4.25 in 1980. The curve decreases to almost 2 in 1981; it increases to about 3.75 at the start of 1982, dips to about 3.5 by midyear, then continues upward to reach about 9.25 in 1983. The curve drops through 1986 to just below 2, fluctuates between about 1.5 and 2.25 in 1987, then continues generally downward through 1989 to just below 0. It increases to approximately 0.25 at the start of 1990, then dips to just below 0 by midyear. The curve starts to increase in 1991, reaching just below 4 by 1992. It decreases to approximately 2.25 in 1993, increases to about 3 in 1994, then drops to about 1 in 1995. The curve moves to about 0 through 1997. It continues generally downward through 1999 to reach about negative 3, then stays about there through 2000. The curve increases through 2003 to about 2.75, decreases to about 1.75 at the start of 2004, then increases slightly to end at about 1.8 by year-end.

The composite curve starts at about 18 dollars per barrel in 1948, then increases to approximately 25 and remains at about that level through 1950. The curve dips to just above 20 through 1952, then increases to about 24 in 1953. The curve decreases through 1956 to reach about 22, then increases to about 24 in 1957. The curve decreases through 1973 to reach about 18, then rises to just below 30 in 1974. It then fluctuates between about 28 and just below 30 through 1979. It increases through mid-1981 to reach about 68, then falls through 1986 to about 18. It increases in 1987 to reach about 28, then decreases to about 19 in 1989. The curve increases, fluctuating between about 24 and 26 through the start of 1990, then decreases to about 22 by the end of the year. The curve climbs to almost 40 in 1991, then continues generally downward to reach about 20 in 1992. It increases to about 24 in 1993, after which it drops to approximately 17 in 1994. The curve then increases, fluctuating between almost 20 and a bit above 20 through 1996. It continues upward in 1997 to reach about 27, then falls through 1999 to about 12. The curve climbs to about 32 through 2001, decreases to about 19 in 2002, increases to about 32 at the start of 2003, and falls to about 28 by midyear. The curve then increases to end at about 36 in 2004:Q2.

Appendix 3: Materials used by Mr. Madigan

Material for **FOMC Briefing on Monetary Policy Alternatives**
Brian Madigan
August 10, 2004

Strictly Confidential (FR) Class I - FOMC

Exhibit 1

Financial Market Developments

Top-left panel
Bond Yields

A line graph shows the ten-year A corporate bond yield and the ten-year Treasury yield. Over the intermeeting period, both yields fell, with the ten-year Treasury falling nearly 45 basis points, to about 4.4 percent.

Top-right panel
Equity Prices

A line graph displays the Nasdaq and S&P 500 indexes from January to August 2004. Both indexes were roughly stable through late June, then fell sharply in July and August. The S&P 500 index fell by more than 6 percentage points, while the Nasdaq fell by nearly 13 percentage points.

Middle-left panel
Expected Federal Funds Rates*

A line chart displays the expected path of the federal funds rate embedded in futures quotes as of June 29, August 5, and August 9, 2004. This chart indicates a downward revision of the expected path of the fed funds rate over the intermeeting period. Futures quotes suggested that investors anticipated the federal funds rate to rise to about 3.5 percent by August 2006.

* Estimates from federal funds and Eurodollar futures, with an allowance for term premia and other adjustments. Return to text

Middle-right panel
Implied Probability of Policy Moves at the August FOMC Meeting*

A bar chart shows the probability of policy moves at the August FOMC meeting, implied by federal fund futures as of June 30 and August 9, 2004. The chart illustrates that options on federal funds futures suggest that market participants had revised up their odds of a 25 basis point policy tightening at the August FOMC meeting over the intermeeting period.

* Risk-neutral probabilities based on options on federal funds futures. Return to text

Bottom-left panel
Results of Dealer Survey

- All the dealers expect the FOMC to tighten policy by 25 basis points today.
- All the dealers expect the risk assessment for growth and inflation to remain balanced.
- Most dealers expect the statement will retain the "measured" language.

Bottom-right panel
Expected Federal Funds Rates*

A line chart plots the expected federal funds rate through December 2004, assuming action only at regularly scheduled meetings, as of June 29 and August 9. The expected path of the federal funds rate moved down over the intermeeting period.

* Based on federal funds futures rates at the close of trading. Estimates assume a 1.0 basis point per month term premium and zero probability of intermeeting moves. Return to text

Exhibit 2
The Case For Unchanged Policy

Top-left panel
Change in Payroll Employment

A bar chart displays the monthly change in payroll employment from June 2003 to July 2004. The series surged early in 2004, but fell off sharply over May, June, and July.

Top-right panel
Staff Real GDP Forecast

Percent Growth, Annual Rate

		June Greenbook	August Post Emp. Rpt.
2003		4.3	4.4
2004:	H1	4.6	3.8
	H2	5.0	3.9
2005		3.6	3.6

Middle panel
Staff Output Gap Forecast

A line chart plots the staff forecast of the output gap from the first quarter of 2000 to the fourth quarter of 2005. After rising to over 2 percent in early 2003, the output gap was projected to shrink slowly and still be around 1 percent at the end of 2005.

Bottom-left panel
Staff Inflation Forecast (August Greenbook)

Percent, Annual Rate

		Core PCE	Overall PCE
2003		1.2	1.7
2004:	H1	2.0	3.3
	H2	1.7	1.5
2005		1.5	1.2

Bottom-right panel
Inflation Expectations

A line chart plots several measures of inflation expectations. Both measures of market-based inflation expectations, over the next five years (TIPS*), and five to ten years ahead (TIPS*), declined over the intermeeting period. Similarly, long-term inflation expectations implied by the results of the Michigan Survey (median, monthly) also came down.

* Based on a comparison of the TIPS yield curve to an estimated nominal off-the-run Treasury yield curve. Final observation is August 9, 2004. Return to text

Exhibit 3
The Case For Tighter Policy

Top panel
Range of Estimated Equilibrium Real Rates

A line graph shows the actual real federal funds rate and the range of estimates for the equilibrium real federal funds rate. The historical average calculated over the 1964:Q1-2004:Q2 period is plotted as a horizontal line at 2.62 percent. The chart shows that the current level of the actual real federal funds rate is negative and sits noticeably below the lower bound of the range of estimates of the equilibrium real funds rate. The estimated range of the equilibrium real federal funds rate is currently about 0 to 2 percent.

Note. The shaded range represents the maximum and the minimum values each quarter of four estimates of the equilibrium real federal funds rate. A four-quarter moving average of core PCE inflation is used as a proxy for inflation expectations.

Middle panel
Values from Policy Rules and Futures Markets

A line graph displays the actual federal funds rate from 1999 through August 2004 and the staff's forecast for the federal funds rate thereafter. Also plotted is a range of maximum and minimum values each quarter of the prescriptions from five estimated policy rules based on the output gap and core PCE inflation. The actual federal funds rate sits just above the lower bound of the range of policy prescriptions and the forecast is within the range of prescriptions.

Bottom-left panel
Rationale for Alternative C (+50 b.p.)

- Negative real federal funds rate.
- Financial conditions mostly supportive of growth.
- Economic activity likely to accelerate.
- Risks to inflation expectations and inflation.

Bottom-right panel
Rationale for Alternative B (+25 b.p.)

- Inflation expectations contained.
- Recent data suggests policy firming can be measured.
- Projected persistence of slack.
- Market expects a 25-basis-point hike today.

Third Revision of Table 1: Alternative Language for the August FOMC Announcement

	June FOMC	Alternative A	Alternative B	Alternative C
Policy Decision	1. The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 1-1/4 percent.	The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1-1/4 percent.	The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to	The Federal Open Market Committee decided today to raise its target for the federal funds rate by 50 basis points to

	June FOMC	Alternative A	Alternative B	Alternative C
			1-1/2 percent.	1-3/4 percent.
Rationale	2. The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity.	The Committee believes that the accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity.	[Unchanged]	The Committee continues to believe that robust underlying growth in productivity is providing ongoing support to economic activity.
	3. The evidence accumulated over the intermeeting period indicates that output is continuing to expand at a solid pace and labor market conditions have improved.	The evidence accumulated over the intermeeting period indicates a moderation in output growth and some slowing in the pace of improvement in labor market conditions.	In recent months, output growth has moderated and the pace of improvement in labor market conditions has slowed. This softness likely owes importantly to the substantial rise in energy prices. The economy nevertheless appears poised to resume a stronger pace of expansion going forward.	The evidence accumulated over the intermeeting period indicates that output growth has moderated but appears poised to resume a stronger pace going forward.
	4. Although incoming inflation data are somewhat elevated, a portion of the increase in recent months appears to have been due to transitory factors.	Recent inflation data have been somewhat elevated, though a portion of the rise in prices evidently reflects transitory factors.	Inflation has been somewhat elevated this year, though a portion of the rise in prices evidently reflects transitory factors.	Although a portion of the rise in inflation this year appears to have been due to transitory factors, continuing and substantial increases in energy prices are putting persistent upward pressure on costs and overall prices.
Assessment of Risk	5. The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters are roughly equal.	[Unchanged]	[Unchanged]	In current circumstances, the Committee believes that the existing degree of policy accommodation, if sustained over the next few quarters, could foster economic growth that is more likely to be above than below its long-run sustainable

	June FOMC	Alternative A	Alternative B	Alternative C
				pace. Similarly, with respect to the Committee's goal of price stability, such an unchanged policy stance implies greater risks to the upside than the downside.
	6. With underlying inflation still expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.	With underlying inflation still expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to promote price stability and sustainable growth.	[Unchanged]	[None]

Last update: April 30, 2010