The Federal Reserve Board

# Meeting of the Federal Open Market Committee
# September 21, 2004 Presentation Materials -- Text Version

Presentation Materials (2.37 MB PDF)

Pages 90 to 100 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**: June 14, 2004 - September 17, 2004
**Description**: Forward rate agreements decrease slightly while LIBOR increases slightly.

#### Middle-left panel

**Title**: 2-Year Treasury Yield
**Series**: Yield for the 2-year Treasury note
**Horizon**: June 14, 2004 - September 17, 2004
**Description**: Yield on 2-year Treasury note decreases slightly.

#### Middle-right panel

**Title**: 10-Year Treasury Yield
**Series**: Yield for the 10-year Treasury note
**Horizon**: June 14, 2004 - September 17, 2004
**Description**: Yield on 10-year Treasury note decreases.

#### 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**: June 14, 2004 - September 17, 2004
**Description**: The Treasury yield 2- and 10-year spread narrows.

### Page 2

#### Top panel

**Title**: 2-Year Treasury Yields During Fed Tightening Cycles

**Series**: 2-year Treasury yields during federal funds tightening cycles
**Horizon**: 1994 - 2004
**Description**: 2-year Treasury yields decline during 2004 Federal Reserve interest rate tightening and increase during 1994 and 1997 tightening cycles.

#### Middle panel

**Title**: 10-Year Treasury Yields During Fed Tightening Cycles
**Series**: 10-year Treasury yields during federal funds tightening cycles
**Horizon**: 1994 - 2004
**Description**: 10-year Treasury yields decline during 2004 Federal Reserve interest rate tightening and increase during 1994 and 1997 tightening cycles.

#### Bottom panel

**Title**: 10-Year Swap Spread During Fed Tightening Cycles
**Series**: 10-year swap spread during federal funds tightening cycles
**Horizon**: 1994 - 2004
**Description**: 10-year swap spread declines during 2004 Federal Reserve interest rate tightening and increases during 1994 and 1997 tightening cycles.

## Page 3

#### Top-left panel

**Title**: 10-Year TIPS Breakeven Rate
**Series**: 10-year TIPS breakeven rate
**Horizon**: June 14, 2004 - September 17, 2004
**Description**: 10-year TIPS breakeven rate declines sharply.

Source: Barclays

#### Top-right panel

**Title**: Oil Futures Prices
**Series**: Front-month WTI oil contract, twelfth WTI contract
**Horizon**: June 14, 2004 - September 17, 2004
**Description**: Oil prices decrease modestly.

#### Middle-left panel

**Title**: Corporate Debt Spreads
**Series**: Investment grade corporate index option-adjusted spread
**Horizon**: June 14, 2004 - September 17, 2004
**Description**: Investment grade corporate debt spread narrows.

Source: Lehman Brothers

#### Middle-right panel

**Title**: High Yield and EMBI+ Spreads
**Series**: EMBI+ spread and high yield bond index option-adjusted spread
**Horizon**: June 14, 2004 - September 17, 2004

**Description**: High yield and EMBI+ spreads narrow.

Source: Merrill Lynch, JP Morgan

**Bottom panel**

**Title**: Select Equity Indices
**Series**: Equity prices for the FTSE 100, S&P 500, Nikkei, DAX, and KOSPI indices
**Horizon**: June 14, 2004 - September 17, 2004
**Description**: Global equity indices increase while the Nikkei declines.

## Page 4

**Top panel**

**Title**: Implied Volatility on S&P 500 Index
**Series**: VIX index of implied volatility
**Horizon**: January 4, 1999 - September 17, 2004
**Description**: Implied volatility on S&P 500 at low levels relative to recent history.

**Middle panel**

**Title**: Implied Volatility of Major Currency Pairs
**Series**: 1-month implied volatility in dollar-yen and 1-month implied volatility in euro-dollar
**Horizon**: January 4, 1999 - September 17, 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 - September 17, 2004
**Description**: Swaption volatility declines.

## Page 5

**Top panel**

**Title**: Daily Fed Funds Rates: High, Low and Effective Rates and Target Rate
**Series**: Federal funds effective rate, federal funds target rate, and intervention rate
**Horizon**: July 22, 2004 - September 1, 2004
**Description**: Fed funds effective rates reached lows in August.

**Bottom panel**

**Title**: Average Excess Balances to Date
**Series**: Average excess balances for maintenance period ending 8/18/2004 and median excess balances for 2004
**Horizon**: August 5, 2004 - August 18, 2004
**Description**: Average excess balances near median levels after mid-quarter refunding.

## Appendix 2: Materials used by Mr. Reinhart

### Exhibit 1
### Financial Market Developments

#### Top-left panel
#### Expected Federal Funds Rates*

A line chart plots the expected federal funds rate implied by federal funds futures rates through the end of 2005, as of August 4, August 9, and September 20, 2004. This chart indicates a rotation in the path of the expected federal funds rate over the intermeeting period leaving the path a little higher in the very near term but noticeably lower at horizons beyond six months.

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

#### Top-right panel
#### Expected Federal Funds Rates Assuming Action Only at Regularly Scheduled Meetings

A line chart plots the expected federal funds rate at the September, November, and December meetings based on futures data as of September 20. The expected rates are 1.73, 1.9, and 1.96 percent for the September, November, and December meetings, respectively.

Note. Estimates from federal funds futures with an allowance for term premia and other adjustments.

#### Middle-left panel
#### Eurodollar Implied Volatility

A line chart displays the implied Eurodollar volatility calculated on a notional contract with 120 days to expiration. The chart shows a declining trend in the series from about 230 basis points in June 2004 to about 175 basis points in September 2004.

#### Middle-right panel
#### Response to Nonfarm Payroll Surprise

A scatter plot displays nonfarm payroll surprises on the horizontal axis against the change in the ten-year Treasury yield in the half-hour surrounding the release of the surprises on the vertical axis. Two regression lines are plotted. The first regression line is based on data from 1994 to 2003, and the second regression line is based on data from 2004. Comparing the two regression lines indicates the average response to employment surprises in the last year has been considerably more marked than in the prior ten years.

#### Bottom-left panel
#### Corporate Yields

A line chart displays yields for five-year high-yield and ten-year BBB corporate bonds in mid-2004. The yields decline gently from June to September.

#### Bottom-center panel
#### Equity Indexes

A line chart displays the NASDAQ and S&P 500 indexes for June through September 2004. After falling from June to mid-August, both indexes increased substantially over the intermeeting period.

**Bottom-right panel**
**Major Currencies Index**

A line chart displays the exchange value of the dollar against an index of major currencies from June through September 2004. The series were little changed, on net, over the intermeeting period.

## Exhibit 2
## The Case for No Change

**Top panel**

- The output gap is expected to persist until the end of 2006.
- The Committee may be quite uncertain whether output growth really has "regained traction."
- Recent inflation readings have been quite benign.

**Middle-left panel**
**Change in Private Nonfarm Payrolls**

A bar chart shows the monthly change in private nonfarm payrolls from January 2004 to August 2004. The series displays an advance to about 350 thousand jobs in March followed by smaller gains from April through August.

**Middle-right panel**
**Core CPI - Current Methods Basis**

A line chart shows the 3-month and 12-month changes in the core CPI, from 1997 to late 2003. In August, both series began to move somewhat lower after more rapid increases earlier in the year.

**Bottom-left panel**
**One-year Forward Rate Maturing Ten Years Ahead***

A line chart shows the one-year forward Treasury rate maturing ten years ahead as estimated from off-the-run coupon securities. The series declined from about 6¾ percent in June 2004 to under 6 percent in September 2004.

* The one-year forward Treasury rate maturing ten years ahead that is implied by a smoothed Treasury yield curve estimated from off-the-run coupon securities. Return to text

**Bottom-right panel**
**Percentage of Economically Refinanceable Mortgages**

A line chart shows the percent of economically refinanceable mortgages at varying interest rates. The series declines from 100 percent of mortgages at a rate of 4½ percent, to less than 10 percent of mortgages for rates greater than 7 percent. At a rate of 5¾ percent, the thirty-year fixed-rate mortgage rate on September 15, 2004, about 35 percent of mortgages were economically refinanceable.

## Exhibit 3

## The Case for Tightening 25 basis points

### Top panel

- The current level of the real federal funds rate is still quite accommodative.
- Financial market conditions have eased.
- The upside risks to the inflation outlook may be quite worrisome.
- Drop the last two sentences if…
  → measured pace language is viewed as constraining the scope of future policy action.
- Retain the last two sentences if…
  → measured pace language is viewed as a useful signal of the Committee's economic and policy outlook.

### Middle-left panel
### Range of Estimated Equilibrium Real Rates

A line graph displays 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 2.72 percent. The chart shows that the current level of the actual real federal funds rate is slightly above the lower bound of the range of estimates of the equilibrium real federal funds rate. The estimated range of the equilibrium real federal funds rate is about 0 to 2 percent.

An explanatory note is provided in Chart 5 of the Bluebook.

### Middle-right panel
### Values from Policy Rules and Futures Markets

A line chart displays the actual federal funds rate from 1995 through September 2004 and the staff's forecast 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 as of September 2004.

An explanatory note is provided in Chart 6 of the Bluebook.

### Bottom-left panel
### Risk Measures

| | Change | Level |
|---|---|---|
| Ten-year AA spread | -5 | 65 |
| Ten-year BBB spread | -6 | 123 |
| Five-year High Yield spread | -17 | 438 |
| S&P 500 Forward Price-Earnings Ratio | 0.81 | 15.97 |

Change is over the intermeeting period. Risk spreads are measured in basis points. The level and change for the price-earnings ratio are expressed in index points.

### Bottom-right panel
### Alternative Simulation: "Less Room to Grow" -- Core PCE Inflation

A line chart shows a baseline and an alternative simulation of Core PCE inflation. Under the baseline simulation, core PCE inflation increases to just over 2 percent by the fourth quarter of 2006. Under the "Less Room to Grow " simulation, potential output is lower than in the staff forecast and the output gap is correspondingly lower as well. With less downward pressure on inflation from the output gap, core PCE inflation increases to about 1½ percent in the fourth quarter of 2004, then falls to just over 1 percent by the end of 2006.

### Table 1: Alternative Language for the September FOMC Announcement

| | August 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 1-1/2 percent. | The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1-1/2 percent. | The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 1-3/4 percent. | The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 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] | [Unchanged] |
| | 3. 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. | Even though output appears to have regained some traction after moderating earlier this year, the pace of improvement in labor market conditions remains modest. | After moderating earlier this year partly in response to the substantial rise in energy prices, output **growth** appears to have regained some traction, **and labor market conditions have improved modestly**. ~~The pace of improvement in labor market conditions, however, remains modest.~~ | Output appears to be regaining traction, and labor market conditions have improved modestly. |
| | 4. Inflation has been somewhat elevated this year, though a portion of the rise in prices seems to reflect transitory factors. | Despite the rise in energy prices, inflation and inflation expectations have eased in recent months. | Despite the rise in energy prices, inflation and inflation expectations have eased in recent months. | Inflation and inflation expectations have eased in recent months, but elevated energy prices continue to put upward pressure on costs and prices. |
| **Assessment of Risk** | 5. The Committee perceives the upside and downside risks to the attainment of both | [Unchanged] | The Committee perceives the upside and downside risks to the attainment of both | [Unchanged] |

| | August FOMC | Alternative A | Alternative B | Alternative C |
|---|---|---|---|---|
| | sustainable growth and price stability for the next few quarters are roughly equal. | | sustainable growth and price stability for the next few quarters **to be** ~~are~~ roughly equal. | |
| | 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. | 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. | [None] |

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