# Meeting of the Federal Open Market Committee
# May 3, 2005 Presentation Materials -- Text Version

Presentation Materials (758 KB PDF)

Pages 104 to 116 of the Transcript

## Appendix 1: Materials used by Mr. Kos

### Page 1

#### Top panel

**Title**: Implied Rates of Eurodollar Futures Contracts
**Series**: June 2005 and December 2005 Contracts
**Horizon**: February 15, 2005 - April 29, 2005
**Description**: Forward contracts remained relatively stable.

#### Middle panel

**Title**: Yield Spread Between 2-Year Treasury and Target Fed Funds Rate
**Series**: 2-Year Treasury Yields and target fed funds rate
**Horizon**: June 1, 2004 - April 29, 2005
**Description**: The 2-year Treasury and Target Fed Funds Rate spread narrowed.

#### Bottom panel

**Title**: 10-Year Treasury Yield Change Since Start of Fed Tightenings
**Series**: 1994-1995, 1999-2000, 2004-2005
**Horizon**: 1-10 Months Ahead
**Description**: In 2004-2005 the 10-year Treasury yield is forecasted to decline slightly.

### Page 2

#### Top panel

**Title**: Yield Spread Between 2- and 10-Year Treasury Notes
**Series**: 2-year and 10-year Treasury notes
**Horizon**: February 15, 2005 - April 29, 2005
**Description**: The 2- and 10-year Treasury note spread narrowed.

#### Middle-left panel

**Title**: Investment Grade Spreads by Ratings Category
**Series**: BBB, A, and AA

**Horizon**: January 1, 1997 - April 29, 2005
**Description**: The investment grade spreads have returned to previous levels.

Source: Lehman Brothers

### Middle-right panel

**Title**: Investment Grade Spreads by Ratings Category
**Series**: BBB, A, and AA
**Horizon**: January 1, 2005 - April 29, 2005
**Description**: Narrowing in on this time frame, the investment grades increased.

Source: Lehman Brothers

### Bottom-left panel

**Title**: Emerging Market Debt Spreads
**Series**: EMBI+
**Horizon**: January 1, 1997 - April 29, 2005
**Description**: The EMBI+ spread has returned to previous levels.

Source: JP Morgan

### Bottom-right panel

**Title**: Emerging Market Debt Spreads
**Series**: EMBI+
**Horizon**: January 1, 2005 - April 29, 2005
**Description**: Narrowing in on this time frame, the EMBI+ spread widened.

Source: JP Morgan

## Page 3

### Top panel

**Title**: 5-Year Credit Default Swaps
**Series**: GM, GMAC, and Ford 5-year CDS
**Horizon**: January 1, 2004 - April 29, 2005
**Description**: The credit default swap index increased for GM, GMAC, and Ford.

### Middle panel

**Title**: Auto and High Yield Index Spreads
**Series**: CCC Index, B Index, BB Index, GM 2013 Bond, and Ford 2013 Bond
**Horizon**: January 1, 2004 - April 29, 2005
**Description**: The auto and High Yield index spreads widened.

Source: Merrill Lynch

### Bottom-left panel

**Title**: Weekly High Yield Issuance
**Series**: Weekly high yield issuance

**Horizon**: January 7, 2005 - April 28, 2005
**Description**: Weekly high yield issuance declined.

Source: Reuters

### Bottom-right panel

**Title**: Composition of Lehman Brothers High Yield Index if GM Were Downgraded
**Series**: GM, Qwest, El Paso, Charter Comm, AT&T, HCA, Calpine, Williams, Georgia Pacific, Edison Intl.
**Horizon**: N/A
**Description**: If GM were downgraded it would be about 6% of Lehman Brothers High Yield Index.

Source: The Yield Book, Lehman Brothers

## Page 4

### Top panel

**Title**: Implied Volatility of the S&P 500
**Series**: VIX Index of Implied Volatility on S&P 500
**Horizon**: January 1, 2004 - April 29, 2005
**Description**: The volatility slightly decreased.

### Middle panel

**Title**: Implied Swaption Volatility
**Series**: 1-month volatility on 2-year swaption and 1-month volatility on 10-year swaption
**Horizon**: January 1, 2004 - April 29, 2005
**Description**: Both the 1-month volatilities on the 2-year and 10-year swaption decreased.

### Bottom 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 1, 2004 - April 29, 2005
**Description**: Both the 1-month implied volatilities on the dollar-yen and the euro-dollar decreased.

## Page 5

### Top panel

**Title**: 30-Year Treasury and 30-Year Bond
**Series**: 30-year Treasury and 30-year Bond
**Horizon**: January 1, 2005 - April 29, 2005
**Description**: The yields for the 30-year Treasury and the 30-year Bond decreased.

### Middle panel

**Title**: Spread of 10-Year Euro Bond Yields to 10-Year Euro Swap Rates
**Series**: 10-year Euro Bond to 10-year Euro Swap spread for Greece, Italy, Spain, Germany, and

France
**Horizon**: January 1, 1999 - April 29, 2005
**Description**: The spread of 10-year Euro Bond Yields to 10-Year Euro Swap Rates widened for Greece, Italy, Spain, Germany, and France.

**Bottom panel**

**Title**: Long-Dated Euro-Area Sovereign Debt Issuance (Greater than 10 Years)
**Series**: Germany, France, and Italy, and all others
**Horizon**: 2000-2005 YTD
**Description**: The debt issuance for Germany, France, and Italy has decreased, while it increased for all others.

## Appendix 2: Materials used by Mr. Reinhart

### Exhibit 1
### Policy Expectations and Financial Conditions

Exhibit 1 reports on policy expectations and financial conditions.

**Top-left panel**
**Desk Survey of Primary Dealers**

- Quarter-point tightening fully anticipated.
- Along with balanced risk assessment.
- One-quarter believe 'measured pace' will be dropped

**Top-right panel**
**Federal Funds Futures**

A line chart displays a time series of the December 2005 federal funds futures contract and the May 2005 contract. The May contract suggests that market participants expect the funds rate target will be set at 3 percent following this meeting. The December 2005 contract suggests that market participants believe that the funds rate could be tightened a further 75 basis points by the end of the year.

**Middle-left panel**
**Two-Year Treasury Change in Response to FOMC Statement and Minutes Releases**

A bar chart displays the responses of the two-year Treasury yield in narrow time intervals bracketing the release of recent FOMC statements and minutes. The chart indicates that the market response to the March FOMC statement was an unusually large increase. Some of that increase was reversed following the release of the minutes of the meeting.

Note. Change in the on-the-run two-year Treasury yield from 15 minutes before to 1 hour after the release.

**Middle-right panels**
**Two-year Treasury Change in Response to Economic Data, and Correlations between the S&P500 and the Two-year Treasury**

Two stacked charts display response of the two-year Treasury yield to economic data over recent intermeeting periods. The second chart displays the correlation between the S&P 500 and the two-year Treasury yield over these same time periods. The first chart indicates that the two-year Treasury yield has generally moved up in response to incoming data over recent intermeeting periods. The second chart notes that the correlation between the S&P 500 and the two-year Treasury yield has been large and positive over the most recent intermeeting period.

### Bottom panels

Three line charts display time-series of the Wilshire stock price index, investment- and speculative-grade bond yields, and an index of the exchange value of the dollar.

#### Bottom-left panel
#### Wilshire Index

The chart indicates that stock prices have dropped since the last meeting.

#### Bottom-center panel
#### Corporate Yields

The chart shows that speculative-grade bond yields have risen appreciably since March while investment-grade bond yields have drifted lower.

#### Bottom-right panel
#### Nominal Major Currencies Dollar Index

The chart shows that the exchange value of the dollar has edged up since the March meeting.

## Exhibit 2
## The Case for Tightening

Exhibit 2 presents the case for tightening by 25 basis points.

### Top-left panel
### Output Gap

A line chart plots the current staff estimate of the output gap along with estimates of the gap as of the March Greenbook. The chart indicates that the projected magnitude of the output gap is now considerably larger than in March.

### Top-right panel
### Core PCE Inflation*

A line chart shows that the projected path for core PCE inflation has revised up since the March Greenbook.

* Four-quarter percent change. Return to text

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

A chart plots the level of the real federal funds rate and a range of estimates of the equilibrium real funds rate over the period from 1990 to present. The chart indicates that the current level of the real federal funds rate remains below the range of estimates of the equilibrium real rate.

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

**Bottom-left panel**
**Expected Federal Funds Futures Rate**

A chart displays the expected path of the funds rate based on federal funds futures quotes and a hypothetical path that would involve a quarter-point tightening at each upcoming meeting through the end of 2006. The futures path suggests that the market anticipates the Federal Reserve will stop tightening at some point in the next few meetings.

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

**Bottom-right panel**
**Cumulative Probability of First FOMC Meeting Without Tightening**

A bar chart displays the cumulative probability of the first FOMC meeting without tightening. The chart indicates that investors see significant odds that the process of policy tightening may be completed by the middle of 2006.

## Exhibit 3
## The Case for Pausing Soon

Exhibit 3 presents the case for pausing soon.

**Top-left panel**
**Values from Policy Rules and Futures Markets**

A chart plots the level of the funds rate and the prescriptions from a range of interest rate rules. The current level of the funds rate is at the upper end of the range of interest rate rule prescriptions. In addition, the prescriptions tend to flatten out over the next year based on the staff's outlook for output and inflation.

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

**Top-right top panel**
**Imposed Coefficients: \pi^* = 1.5**

| | Q1 | Q2 |
|---|---|---|
| Baseline Taylor Rule | 2.70 | 3.16 |
| Aggressive Taylor Rule | 2.12 | 2.56 |
| First-Difference Rule | 2.31 | 2.80 |

**Top-right bottom panel**
**Imposed Coefficients: \pi^* = 2.0**

| | Q1 | Q2 |
|---|---|---|
| Baseline Taylor Rule | 2.45 | 2.91 |
| Aggressive Taylor Rule | 1.87 | 2.31 |
| First-Difference Rule | 2.06 | 2.55 |

**Middle-left panel**
**Unemployment Rate**

A line chart displays the staff forecast for the unemployment rate along with the forecasts for the unemployment rate in a scenario in which the economy turns down sharply. In this scenario, the unemployment rate increases to 6-1/4 percent by the end of 2006.

**Middle-right panel**
**Core PCE Inflation***

A line chart displays the corresponding forecasts for core PCE inflation. The weaker economy scenario generates a significantly lower path for inflation than the baseline.

* Rate of inflation over previous four quarters. Return to text

**Bottom-left panel**
**Employment Cost Index Growth***

A line chart shows the employment cost index over recent years. The series has been trending down since late 2003 and recorded a sizable drop in the first quarter of 2005.

* Rate of growth over previous four quarters. Return to text

**Bottom-right panel**
**Inflation Expectations**

A line chart displays measures of long-term inflation expectations. The Michigan survey of long-term inflation expectations has edged up over recent months. However, five-year forward inflation compensation has trended down since 2004 and has edged down recently as well.

## Exhibit 4
## The Case for Pushing up the Pace of Tightening

Exhibit 4 presents the case for pushing up the pace of tightening.

**Top panel**
**Core PCE Inflation**

A line chart displays the core PCE inflation rate (3-month moving average, and central tendency*). The series has moved up lately to a level that is well above where policymakers expect inflation to be by the end of 2005.

* The central tendency of the forecast of 4-quarter growth in the core PCE price index made by Federal Reserve governors and Reserve Bank presidents for the February Monetary Policy Report. Return to text

**Middle-left panel**
**Unemployment Rate**

A line chart displays the unemployment rate over the period since the middle of 2003. The rate has dropped appreciably since the middle of 2003 and currently is at a level of 5-1/4 percent.

**Middle-right panel**
**Actual Productivity Growth***

A line chart displays recent productivity growth in the nonfarm business sector. The chart indicates that productivity growth has slowed since 2003.

* Quarterly growth of output per hour in the nonfarm business sector. Return to text

**Bottom panel**
**WTI Oil Price**

A line chart displays time series for the spot and distant horizon WTI oil price. Both series have risen substantially since the beginning of 2004.

## Exhibit 5
## Forward Looking Elements of March Statement Language

[Note: Footnotes have been added to represent color-coded notes in the original document.]

The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 2-3/4 percent.

The Committee believes that, even after this action, **the stance of monetary policy remains accommodative**[blue] and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. Output evidently continues to grow at a solid pace despite the rise in energy prices, and labor market conditions continue to improve gradually. Though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident. The rise in energy prices, however, has not notably fed through to core consumer prices.

The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. **With underlying inflation expected to be contained,**[red1] **the Committee believes that policy accommodation can be removed at a pace that is likely to be measured.**[red2] Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

[blue] Characterization of policy stance as "accommodative." Return to text

[red1] Characterization of inflation outlook. Return to text

[red2] Pace of removal of accommodation Return to text

## Exhibit 6
## Table 1: Alternative Language for the May FOMC Announcement

[Note: In Appendix 2, Exhibit 6, Table 1, emphasis (strike-through) has been added to indicate strike-through text in the original document. Strong emphasis (bold) indicates bold red text in the original document.]

| | March 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 2-3/4 percent. | The Federal Open Market Committee decided today to raise its target for the federal funds rate ~~by~~ **a further** 25 basis points to **3** percent. | The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to **3** percent. | The Federal Open Market Committee decided today to raise its target for the federal funds rate by **50** basis points to **3-1/4** percent. |

| | March FOMC | Alternative A | Alternative B | Alternative C |
|---|---|---|---|---|
| | 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, even after this action, the stance of monetary policy remains **somewhat** accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. | [no change] | 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. |
| Rationale | 3. Output evidently continues to grow at a solid pace despite the rise in energy prices, and labor market conditions continue to improve gradually. | **Recent data suggest that the solid pace of spending growth has slowed, partly in response to** ~~Output evidently continues to grow at a solid pace despite the rise in~~ **the earlier increases in** energy prices**.** ~~, and labor~~ **Labor** market conditions**, however, apparently** continue to improve gradually. | **Recent data suggest that the solid pace of spending growth has slowed somewhat, partly in response to** ~~Output evidently continues to grow at a solid pace despite the rise in~~ **the earlier increases in** energy prices**.** ~~, and labor~~ **Labor** market conditions**, however, apparently** continue to improve gradually. | Output ~~evidently~~ continues to grow at a ~~solid~~ pace ~~despite the rise in energy prices, and labor market conditions continue to improve gradually.~~ **sufficient to eliminate any remaining resource slack.** |
| | 4. Though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident. The rise in energy prices, however, has not notably fed through to core consumer prices. | ~~Though longer-term inflation expectations remain well contained, pressures~~ **While pressures** on inflation have picked up in recent months, and pricing power is more evident**, longer-term inflation expectations remain well contained.** ~~The rise in energy prices, however, has not notably fed through to core consumer prices.~~ | ~~Though longer-term inflation expectations remain well contained, pressures~~ **Pressures** on inflation have picked up in recent months, and pricing power is more evident. **Longer-term inflation expectations remain well contained.** ~~The rise in energy prices, however, has not notably fed through to core consumer prices.~~ | Though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident. ~~The rise in energy prices, however, has not notably fed through to core consumer prices.~~ |
| | 5. The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. | The Committee perceives that, with appropriate monetary policy ~~action~~, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. | [no change] | ~~The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal.~~ |
| Assessment of Risk | 6. With underlying inflation expected to be contained, 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 expected to be ~~contained~~ **relatively low**, the Committee believes that **remaining** 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. | [no change] | ~~With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless,~~ **T**he Committee will respond to changes in economic prospects as needed to fulfill its obligation **to foster the attainment of both sustainable economic growth and** ~~maintain~~ price stability. |