Meeting of the Federal Open Market Committee September 20, 2005 Presentation Materials -- Text Version

Presentation Materials (992 KB PDF)

Pages 105 to 117 of the Transcript

Appendix 1: Materials used by Mr. Kos

Page 1

Top panel

Title: Current US 3-Month Deposit Rates and Rates Implied by Traded Forward Rate Agreements
Series: LIBOR fixed, 3-month forward, and 9-month forward
Horizon: April 1, 2005 - September 16, 2005
Description: The US 3-month forward and 9-month forward rates increased.

Middle panel

Title: 2- and 10-Year Treasury Yields and Target Fed Funds
Series: 2-Year Treasury Yield, 10-Year Treasury Yield and target Fed Funds rate
Horizon: April 1, 2005 - September 16, 2005
Description: The 10-year Treasury yield decreased, while the 2-year Treasury yield and the target Fed Funds rate increased.

Bottom panel

Title: Breakeven Inflation Curve
Series: Current (9/16/05), Pre-Katrina (8/26/05), and August FOMC (8/9/05)
Horizon: January 2007 - April 2032
Description: The breakeven inflation curve is predicted to decrease.

Page 2

Top panel

Title: TIPS Yield Curve
Series: Current (9/16/05), Pre-Katrina (8/26/05), and August FOMC (8/9/05)
Horizon: January 2007 - April 2032
Description: TIPS yield curve is predicted to increase.

Middle-left panel

Title: Global Equity Indices

Series: Brazil Bovespa, Mexico Bolsa, Europe Stoxx, Nikkei, and S&P 500
Horizon: July 1, 2005 - September 16, 2005
Description: The global equity indices increased.

Middle-right panel

Title: Select Equity Performance
Series: Energy, Utilities, Healthcare, Financials, S&P 500, Technology, Materials, Industrials, Consumer Staples, and Cons. Discretionary
Horizon: August 26, 2005 - September 16, 2005
Description: Equity performance increased other than cons. discretionary which decreased.

Source: S&P Exchange Traded SPDR Funds

Bottom panel

Title: Municipal Bonds Spreads to Treasuries
Series: New Orleans 2029 and Municipal Bond Index
Horizon: July 1, 2005 - September 15, 2005
Description: The spreads narrowed.

Source: Bond Buyer

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Top-left panel

Title: Front Month Gasoline Futures 1-Month Implied Volatilities
Series: Front Month Gasoline Futures 1-Month Implied Volatilities
Horizon: January 3, 2005 - September 16, 2005
Description: The front month gasoline futures 1-month implied volatilities increased.

Source: Bloomberg

Top-right panel

Title: 1-Month Implied Swaption Volatility
Series: 1-year swaption and 10-year swaption
Horizon: January 3, 2005 - September 16, 2005
Description: 1-year swaption increased, while the 10-year swaption fell.

Source: Goldman Sachs

Middle-left panel

Title: VIX Implied Volatility on the S&P 100
Series: VIX Implied Volatility on the S&P 100
Horizon: January 3, 2005 - September 16, 2005
Description: The VIX implied volatility on the S&P 100 decreased.

Middle-right panel

Title: Euro-Dollar and Dollar-Yen 1-Month Implied Volatility

Series: Euro Dollar and Yen Dollar 1-month implied volatility
Horizon: January 3, 2005 - September 16, 2005
Description: Both the euro dollar and dollar yen 1-month implied volatilities decreased.

Bottom-left panel

Title: Investment Grade OAS Spread
Series: Investment Grade option-adjusted Spread
Horizon: January 3, 2005 - September 16, 2005
Description: The investment grade OAS spread widened.

Source: Lehman Brothers

Bottom-right panel

Title: High Yield and Emerging Markets Indices
Series: High yield and EMBI+
Horizon: January 3, 2005 - September 16, 2005
Description: The high yield increased, while the EMBI+ decreased.

Source: Merrill Lynch, JP Morgan

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Top panel

Title: Peak Open Interest in 10-Yr Treasury Futures Contract vs. Issue Size of Cheapest-to-Deliver Security
Series: Peak open interest for front contracts and original issuance of cheapest-to-deliver security
Horizon: May 1998 - September 2005
Description: In September 2005 the peak open interest for front contracts was about $160 billion and for original issuance of cheapest-to-deliver securities was about $25 billion.

Middle-left panel

Title: Open Interest in Final Days of Trading of 10-Year Treasury Futures
Series: March 2002
Horizon: Two weeks
Description: Open interest declines within the two weeks prior to termination.

Size of Aug 2010 = $22.4 Bn.

Middle-center panel

Title: Open Interest in Final Days of Trading of 10-Year Treasury Futures
Series: June 2005
Horizon: Two weeks
Description: Open interest declines within the two weeks prior to termination.

Size of Feb 2012 = $24.8 Bn

Middle-right panel

Title: Open Interest in Final Days of Trading of 10-Year Treasury Futures
Series: September 2005
Horizon: Two weeks
Description: Open interest declines within the two weeks prior to termination.

Size of Aug 2012 = $19.6 Bn

Bottom-left panel

Title: Aug-12 Overnight Repo Rate and Fails
Series: Overnight Repo and FICC fails
Horizon: August 15, 2005 - September 16, 2005
Description: Overnight repo decreased, while FICC fails increased.

Bottom-right panel

Title: Treasury Yield Curve in 5- to 10-Year Sector as of 9/15/05
Series: Treasury yield curve in 5-year and 10-year sector
Horizon: November 2010 - August 2016
Description: The closing yield on 9/15/05 was larger for a 10-year maturity Treasury than a 5-year maturity Treasury.

Appendix 2: Materials used by Mr. Reinhart

Material for **FOMC Briefing on Monetary Policy Alternatives**
Vincent R. Reinhart
September 20, 2005

Class I FOMC - Restricted Controlled FR

Exhibit 1
Policy Background

Exhibit 1 reports on recent financial market developments.

Top-left panel
Policy Expectations*

A line chart plots the current expected path of the funds rate derived from federal funds futures quotes and the expected path as of the time of the August FOMC meeting. The chart indicates that investors revised down the expected path for the funds rate over the intermeeting period quite substantially. The current path suggests that investors anticipate the funds rate will plateau at a level around 4 percent by the middle of 2006.

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

Top-right panel
Inflation Compensation*

A line chart displays measures of inflation compensation over the next five years and five years ahead. Both series edged up over the intermeeting period and both ended the period just a little above

2.5 percent.

* Based on a comparison of a smoothed TIPS yield curve to a smoothed nominal off-the-run Treasury yield curve. Return to text

Bottom panels

Three line charts plot the ten-year Treasury yield, the Wilshire stock price index, and corporate risk spreads, respectively, since the beginning of 2004.

Bottom-left panel
Ten-Year Treasury*

The chart indicates that the ten-year Treasury yield has fluctuated in a range between 4 percent and 5 percent over this period and currently stands at a level of about 4.5 percent.

* Par yields from a smoothed nominal off-the-run Treasury yield curve. Return to text

Bottom-center panel
Wilshire 5000

The chart indicates that equity prices have risen substantially since the beginning of 2004 but were about unchanged over the intermeeting period.

Bottom-right panel
Corporate Bond Spreads*

Similarly, the chart on risk spreads indicates that both investment- and speculative-grade corporate risk spreads were little changed over the intermeeting period.

* Measured relative to an estimated off-the-run Treasury yield curve. Return to text

Exhibit 2
Staff Assessment

Exhibit 2 reports on the staff's economic outlook.

Top-left panel
GDP Growth

A bar chart compares GDP growth projections currently with those prepared for the August meeting. The chart indicates that the staff revised down its projection for GDP growth in the second half of 2005 appreciably but revised up its projection for GDP growth in 2006 by a similar amount.

Top-right panel
PCE Inflation

	PCE	Core PCE
2005H1	2.8	2.0
August Greenbook	*2.8*	*2.1*
2005H2	3.8	1.9
August Greenbook	*2.4*	*2.0*

	PCE	Core PCE
2006H1	1.7	2.4
August Greenbook	*2.2*	*2.1*
2006H2	2.0	2.2
August Greenbook	*2.0*	*2.1*

Middle panels

Two line charts plot the optimal path of the nominal and real federal funds rate.

Middle-left panel
Federal Funds Rate

The chart suggests that the optimal funds rate path rises from the current level to a little above 4 percent by the end of 2006. The optimal policy path for the nominal funds rate is nearly identical excluding the economic effects of Hurricane Katrina.

Middle-right panel
Real Federal Funds Rate

The optimal path for the real federal funds rate stays close to about 2 percent over the forecast period. However, the optimal real funds rate would be somewhat higher excluding the economic effects of Hurricane Katrina.

Bottom panels

Two line charts display the projected output gap and core PCE inflation with and without the effects of hurricane Katrina.

Bottom-left panel
GDP Gap

The chart for the output gap suggests that the gap will narrow close to zero by early 2006. Excluding the effects of Katrina, the output gap would narrow considerably faster and would approach zero by the end of 2005.

Bottom-right panel
Core PCE Inflation

The chart for core PCE inflation suggests a sizable pickup in inflation by the middle of 2006 that then fades over time. Excluding the effects of Katrina, the core PCE inflation projection would show a much more modest rise next year.

Exhibit 3
Policy Alternatives

Top panel

Guidance	Action	
	No Change	Increase 25 bps

	Sure	Unsure	Unsure	Sure
Measured Pace	A- [blue]	A	B	B+ [blue]
Risk Formula	[orange]	[orange]	[orange]	[orange]
None	[green]	[green]	[green]	[green]

Middle panel
Stare Decisis

- Stare decisis means "Let the decision stand," to adhere to precedent and not unsettle things that are established.
- Justice Frankfurter noted that it "embodies an important social policy that represents an element of continuity and is rooted in the psychological need to satisfy reasonable expectations."

Bottom-left panel
Probability of a 25 bps Tightening*

A line chart displays the probability of a 25 basis point tightening (3.75 vs. 3.50) at this meeting over the intermeeting period. Early in the period, the probability was almost 100 percent. After the devastation of hurricane Katrina, the probability of tightening fell to about 60 percent but has since risen to about 80 percent.

* Based on October 2005 federal funds contract. Return to text

Bottom-right panel
Desk Survey

- Most of the 22 primary dealers expect key statement features will be retained.
- Only two think the reference to "accommodative" policy will be changed or dropped.
- Three anticipate upside inflation risks. One expects downside growth risks.
- Four expect modification or deletion of the "measured pace" language.

Exhibit 4
Arguments for A and B

Exhibit 4 focuses on arguments for policy easing versus holding the funds rate constant at this meeting. The charts in the left column present arguments for easing policy. The charts in the right column present arguments for leaving policy on hold at this meeting.

Top-left panel
Range of Estimated Equilibrium Real Rates

A chart displays the current level of the real federal funds rate relative to a range of model estimates of the equilibrium real rate. The current level of the real federal funds rate is a little below the range of model-based estimates, suggesting that the stance of monetary policy may still be somewhat accommodative.

See explanatory note in Chart 5 of the Bluebook.

Middle-left panel

Consumer Confidence

A line chart plots a time-series for consumer confidence. The series plunged in September following Hurricane Katrina, suggesting that households could begin to rein in spending.

Source: Michigan SRC

Bottom-left panel
Unemployment

A line chart shows the staff forecast for the unemployment rate under the baseline and under an alternative scenario in which consumer confidence declines markedly. Under the baseline, unemployment is projected to remain at about 5 percent for the next two years. Under the alternative scenario, the unemployment rate rises to about 5.5 percent by the end of 2007.

Top-right panel
Values from Policy Rules and Futures Markets

A chart plots the level of the federal funds rate along with prescriptions from a range of interest rate rules. The chart indicates that interest rate rules would call for the funds rate to be held fairly steady over the next two years given the staff's outlook for output and inflation.

See explanatory note in Chart 6 of the Bluebook.

Middle-right panel
Expected Inflation

A line chart displays measures of inflation expectations from the Michigan survey. The series for long-term inflation expectations has remained fairly steady at about 3 percent, but inflation expectations over the next twelve months jumped sharply in September following the recent spike in oil prices.

Source: Michigan SRC

Bottom-right panel
Core PCE Inflation

A line chart presents the staff's forecast for core PCE inflation under the baseline and an alternative scenario that includes deteriorating inflation expectations. Under the baseline, core PCE inflation is projected to gradually edge down from about 2.4 percent to 2 percent by the end of 2007. Under the alternative scenario, core PCE inflation moves up to about 2.8 percent by the middle of 2006 and then levels out at about 2.4 percent in 2007.

Exhibit 5
Assessment of Risks

[Note: In Appendix 2, Exhibit 5, strong emphasis (bold) has been added to indicate red text in the original document.]

Top panel
Alternative B With Risk Formula

The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 3¾ percent.

Output appeared poised to continue growing at a good pace before the tragic toll of Hurricane Katrina. The widespread devastation in the Gulf region, the associated dislocation of economic activity, and the boost to energy prices imply that spending, production, and employment will be set back in the near term. In addition to elevating premiums for some energy products, the disruption to the production and refining infrastructure may add to energy price volatility.

While these unfortunate developments have increased uncertainty about near-term economic performance, it is the Committee's view that they do not pose a more persistent threat. Rather, monetary policy accommodation, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity.

Higher energy and other costs have the potential to add to inflation pressures. However, core inflation has been relatively low in recent months, and longer-term inflation expectations remain contained.

The Committee's economic outlook is such that, if the federal funds rate were maintained at its current level for the next several quarters, output growth is more likely to be above than below its sustainable pace. Inflation over the same period is more likely to increase than decrease. [As a result, the Committee views the near-term risks to its dual objectives as tilted to the upside.] In any event, the Committee is prepared to take the steps necessary to maintain price stability and sustainable economic growth.

Bottom panel
Alternative B Without Guidance

The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 3¾ percent.

Output appeared poised to continue growing at a good pace before the tragic toll of Hurricane Katrina. The widespread devastation in the Gulf region, the associated dislocation of economic activity, and the boost to energy prices imply that spending, production, and employment will be set back in the near term. In addition to elevating premiums for some energy products, the disruption to the production and refining infrastructure may add to energy price volatility.

While these unfortunate developments have increased uncertainty about near-term economic performance, it is the Committee's view that they do not pose a more persistent threat.

Higher energy and other costs have the potential to add to inflation pressures. However, core inflation has been relatively low in recent months, and longer-term inflation expectations remain contained.

Exhibit 6 (Last Page)
Table 1: Alternative Language for the September FOMC Announcement (September 20, 2005)

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

	August FOMC	Alternative A	Alternative B
Policy Decision	1. 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 leave its target for the federal funds rate unchanged.	The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to

	August FOMC	Alternative A	Alternative B
	3½ percent.		3¾ 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 deferred further policy firming in light of the uncertainties surrounding the economic effects of Hurricane Katrina.	[none / see below]
	3. Aggregate spending, despite high energy prices, appears to have strengthened since late winter, and labor market conditions continue to improve gradually.	Output appeared poised to continue growing at a good pace before the tragic toll of the hurricane. The widespread devastation in the Gulf region, the associated dislocation of economic activity, and the boost to energy prices imply that spending, production, and employment will be set back in the near term. **In addition to elevating premiums for some energy products,** ~~Moreover,~~ the disruption to the production and refining infrastructure ~~has elevated premiums for energy products and~~ may add to **energy price** ~~market~~ volatility.	Output appeared poised to continue growing at a good pace before the tragic toll of Hurricane Katrina. The widespread devastation in the Gulf region, the associated dislocation of economic activity, and the boost to energy prices imply that spending, production, and employment will be set back in the near term. **In addition to elevating premiums for some energy products,** ~~Moreover,~~ the disruption to the production and refining infrastructure ~~has elevated premiums for energy products and~~ may add to **energy price** ~~market~~ volatility. While these unfortunate developments have increased uncertainty about near-term economic performance, it is the Committee's view that they do not pose a more persistent threat. Rather, ~~remaining~~ monetary policy accommodation, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity.
	4. Core inflation has been relatively low in recent months and longer-term inflation expectations remain well contained, but pressures on inflation have stayed elevated.	Higher energy and other costs have the potential to add to inflation pressures. However, core inflation has been relatively low in recent months**,** and longer-term inflation expectations remain ~~well~~ contained.	Higher energy and other costs have the potential to add to inflation pressures. However, core inflation has been relatively low in recent months**,** and longer-term inflation expectations remain ~~well~~ contained.
Assessment of Risk	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.	[no change]	[no change]
	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.	[no change]	[no change]

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