The Federal Reserve Board

Meeting of the Federal Open Market Committee
October 24-25, 2006 Presentation Materials -- Text Version

Presentation Materials (PDF)

Pages 192 to 203 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: U.S. dollar 3-month Libor fixing and 3-month rates 3 months forward, 9 months forward, and 15 months forward
Horizon: January 2, 2006 to October 20, 2006
Description: U.S. 3-month forward rates rose steadily over the period shown until declining modestly in late June 2006. Three-month forward rates leveled off later in September 2006. Nine- and fifteen-month forward rates both rose sharply in early October 2006.

Middle panel

Title: 2- and 10-Year Treasury Yields and Target Fed Funds Rate
Series: 10-year Treasury yield, 2-year Treasury yield, and target federal funds
Horizon: January 2, 2006 to October 20, 2006
Description: Two- and 10-year Treasury yields rose as the target federal funds rate increased, until late June when yields began to decline. Yields decreased dramatically around the September 20, 2006 FOMC meeting (labeled with a tripwire), but rebounded and have risen since early October 2006.

Bottom panel

Title: U.S. Breakeven Inflation Rates
Series: 5-year, 10-year, and 5-year 5-year forward breakeven inflation rates
Horizon: January 2, 2006 to October 20, 2006
Description: All three breakeven inflation rates have fluctuated over the period shown. However, on net, the 5-year 5-year forward breakeven inflation rate has risen, whereas 5-year and 10-year breakeven inflation rates have fallen.

Page 2

Top-left panel

Title: Dow Jones Industrial Average
Series: Dow Jones Industrial Average Index
Horizon: January 2, 2006 to October 20, 2006
Description: The Dow Jones Industrial Average increased substantially since the beginning of August 2006 to the end of the period shown, when it reached the 12,000 mark.

Top-right panel

Title: S&P 500 and NASDAQ
Series: S&P 500 Index and NASDAQ Index
Horizon: January 2, 2006 to October 20, 2006
Description: Both the S&P 500 and NASDAQ Indexes have significantly increased in levels since the beginning of August 2006, causing them to be positive, on net, over the period shown.

Middle-left panel

Title: Performance of Growth vs. Value Stocks
Series: Russell 1000 Value Index and Russell 1000 Growth Index (Indexed to 100 on 6/30/04)
Horizon: June 30, 2004 to October 20, 2006
Description: Both indexes have risen over the period shown as indexed to 100 on June 30, 2004. However, the Russell 1000 Value Index outperformed the Russell 1000 Growth Index.

Middle-right panel

Title: Performance of Growth vs. Value Stocks
Series: Russell 1000 Value Index and Russell 1000 Growth Index (Indexed to 100 on 8/8/06)
Horizon: August 8, 2006 to October 20, 2006
Description: When indexed to 100 on August 8, 2006, the Russell 1000 Growth Index outperformed the Russell 1000 Value Index.

Bottom panel

Title: Select Foreign Currency Performance Against the Dollar
Series: Countries' currencies from left to right include: Brazil, Mexico, Australia, New Zealand, Canada, U.K., South Korea, Euro, Switzerland, and Japan
Horizon: September 20, 2006 to October 20, 2006
Description: The U.S. dollar generally depreciated against higher-yielding currencies (Brazil, Mexico, Australia, and New Zealand) and appreciated versus lower-yielding currencies (Euro, Switzerland, and Japan).

Page 3
Review of Domestic Portfolio Guidelines:

Top panel
Investment Principles

Safety • Liquidity • Neutrality • Return

Middle-left panel
Portfolio Liquidity

- Prompt contraction of portfolio

Liquidity Need Assessment

Scenarios:

- Large-scale discount window borrowing
- FX intervention

Results:

- Refine liquidity guideline
- $80 billion over 3 months
- $208 billion over 1 year

Available Liquidity Tools

- Maturity liquidity: repo
- Maturity liquidity: securities
- Reverse repos
- Outright sales

Middle-right panel
Maturity Profile of SOMA

as of 9/29/2006

		($blns)
Repo	0-1 weeks	18
	1-2 weeks	4
		$22
Bills	0-3 months	197
	3-6 months	80
		$277
Coupons	0-1 year	135
	1-2 year	110
	2-5 year	112
	5-10 year	51
	10-30 year	80
		$488
Total Domestic Portfolio		$786

Bottom panel

Title: Maturity Liquidity Profile as of September 29, 2006
Series: Cumulative bill maturities, cumulative repo maturities, cumulative coupons maturities of SOMA holdings as of September 29, 2006
Horizon: September 2006 to August 2007
Description: The cumulative total amount of maturing funds from bills, repos and coupon holdings

was $100 billion over a 4-week horizon, $254 billion over a 3-month horizon, $371 billion over a 6-month horizon, and $440 billion over the one year horizon. The $80 billion/3-month minimum liquidity requirement was satisfied in less than 3 weeks, while the $208 billion/1-year minimum liquidity requirement was satisfied at approximately the 11 week horizon.

Page 4

Top-left panel
Market Neutrality

- Avoid distortion of market pricing or liquidity

Limit Structure

Conclusion:

- Revert to flat limit structure

Rationale:

- Treasury securities in ample supply
- Avoid market impact at short-end of curve
- Avoid redemptions

Impact:

- No immediate change in portfolio composition
- Alleviate operational burden

Auction Participation

Observation:

- Auction participation can be highly variable
- Dependent on Treasury auction calendar
- Fed add-on purchases add to floating supply and can impact "specialness"of an issue

Conclusion:

- Prefer regular, consistent participation

Constraints:

- Restrictions on investment of maturing proceeds

Top-right panel

Title: SOMA Holdings and Per Issue Limits by Security as of September 29, 2006
Series: Per-issue SOMA holdings of Treasury securities as a percent of outstanding amount for each security, per-issue percentage holding limits
Horizon: October 2006 through February 2036
Description: Existing per-issue holding limits are graduated based on remaining maturity ranging

from 15 percent for securities with 10 years or more to maturity to 35 percent for securities with 1 year or less to maturity. Actual percentage holdings of the SOMA portfolio vary considerably, but were steady at about 30 percent for bill holdings. Holdings of coupon securities with remaining maturity between 0 and 1 year range from 7 to 32 percent, between 1 and 2 years range from 6 to 28 percent, between 2 and 3 years range from 1 to 23 percent, between 3 and 5 years range from 0 to 24 percent, between 5 and 10 years range from 1 to 29 percent, and between 10 and 30 years range from 5 to 22 percent.

Middle-right panel
Abbreviated Forecast SOMA Rollover Schedule

[Note: In Appendix 1, Page 4, Abbreviated Forecast SOMA Rollover Schedule, the three table cells under heading "3-year" have a light-yellow background in the original document.]

Settle Date	Maturing Holdings			($bln)
		3-year	**10-year**	**30-year**
11/15/06	8.4	6.1	2.3	-
2/15/07	3.5	1.5	1.0	1.0
5/15/07	11.3	6.0	2.3	3.0
		2-year	**5-year**	**20-yr TIPS**
1/31/07	6.1	2.5	2.0	1.5
2/28/07	8.7	5.2	3.5	

Bottom panel

Title: SOMA Participation in 5-year Auction Varies Based on Settlement Date
Series: Public offering amounts of the 5-year security, SOMA add-on amount of the 5-year security, average/high/low spread of the specials rate to general collateral during the on-the-run life of each issue
Horizon: January 2004 to August 2006
Description: Prior to February 2006 (labeled with a trip-wire), SOMA only purchased the 5-year note once out of every three auctions, leading to variability in the total issuance size. From February 2006, the settlement date of 5-year note auctions was changed to month-end from mid-month. This change allowed SOMA to purchase the 5-year note auction every month in a more consistent manner leading to less variability in total issue size. The repo spread was wider and more volatile prior to February 2006, when the SOMA participation was less regular.

Appendix 2: Materials used by Mr. Reinhart

Material for **FOMC Briefing on Monetary Policy Alternatives**
Vincent R. Reinhart
October 24-25, 2006

Class I FOMC - Restricted Controlled (FR)

Exhibit 1
Financial Developments

Top panel
Federal funds and Eurodollar futures contract rates

A line chart showing the December 2006 federal funds futures rate and the December 2007 Eurodollar futures rate. The data are at five-minute intervals, and are shown from September 19, 2006 through 3:00 pm on October 24, 2006. Vertical lines show the timing of the September FOMC meeting, the release of the Philadelphia Fed index, new home sales, the ISM, the nonfarm payrolls, and retail sales data, as well as the September FOMC minutes. The December 2006 federal funds futures rate starts the period a bit below 5.3 percent, moves down slightly following the September FOMC meeting, and then is flat at around 5.25 percent for the rest of the period. The December 2007 Eurodollar futures rate starts a little over 5.0 percent, moves down to 4.7 percent by early October, but then rebounds to end the period about where it began it.

Middle-left panel
Expected federal funds rate*

A line chart showing the expected path of the federal funds rate from the fourth quarter of 2006 through the fourth quarter of 2007 as implied by federal funds and Eurodollar futures prices on October 23, 2006. The line starts at about 5.25 percent, remains near that level into 2007, and then slopes gradually down to about 4.75 percent by the end of that year. The chart also shows 70 percent and 90 percent confidence intervals around that path as implied by options prices. These ranges are very narrow for the current quarter, but widen out to about 1.5 and 2 percentage points by the end of 2007.

* Estimates from futures quotes. Seventy- and 90-percent confidence intervals estimated from options prices shown in green and blue, respectively. Estimated from quotes on October 23, 2006. Return to text

Middle-right panel
Alternative federal funds rate projections

A line chart showing three expected paths for the federal funds rate over the final quarter of 2006 and the four quarters of 2007. The Greenbook projection is flat at 5.25 percent. The market path is the same as shown in the middle-left panel. Forecasts from the primary dealers show the funds rate staying at 5.25 percent through the first quarter of next year, then falling to 5.0 percent in the second quarter and remaining at that level though year-end.

Bottom panels

Three line charts showing forecasts from the Greenbook and from a group of primary dealers for the unemployment rate, core CPI inflation, and real GDP growth, respectively.

Bottom-left panel
Unemployment rate

The two forecasts for the unemployment rate are very close together, rising from about 4.75 percent in the fourth quarter of this year to about 5.1 percent at the end of 2007.

Bottom-center panel
Core CPI inflation

The forecasts of core CPI inflation also look similar, falling from near 3 percent in the fourth quarter of 2006 to about 2.4 percent in the final quarter of 2007.

Bottom-right panel
Real GDP growth

By contrast, the forecasts of real GDP growth are quite different, with the Greenbook forecast ranging between 2 and 2.5 percent, while the primary dealers' forecast runs about half a percentage point higher.

Exhibit 2
A Rorschach Test for Your Assessment of the Economy

Top-left panel
Home sales

A line chart showing existing and new home sales on a monthly basis from 1999 to September of this year, 2006. Both lines run up sharply over 2003-2005, and fall back this year. Both lines might show some signs of leveling out more recently.

Top-right panel
Alternative interpretations

- Home sales have declined sharply and the resulting weakness is a risk to the outlook.
- Home sales appear to be bottoming out amid generally strong fundamentals.

Middle-left panel
Real federal funds rate

A line chart showing quarterly values for the real federal funds rate (defined as the nominal federal funds rate less the four-quarter percent change in the core PCE price index) from 1996 to the fourth quarter of 2006. The line starts at about 3.5 percent in 1999, and generally runs above that level until 2001, when it falls sharply to below zero. The rate moves a little lower between 2002 and mid-2004, but then rises to close to 3 percent by the end of this year.

Middle-right panel
Alternative interpretations

- Policy has tightened considerably and may now be restrictive.
- The real federal funds rate remains below its average level in the late 1990s.

Bottom-left panel
Inflation compensation*

A line chart showing daily observations from April 2004 to October 24, 2006 on inflation compensation for the next five years and for five to ten years ahead, measured from yields on nominal and indexed Treasury securities. Inflation compensation for the next five years has ranged between about 2.2 percent and 2.7 percent over this period. It declined over the second half of the summer from about 2.5 to about 2.25, and has remained near that level since. The measure of five year forward inflation compensation moved down from over 3 percent to about 2.5 percent over the first half of the period plotted. It has since moved back up a little, ending the period at about 2.6 percent.

* Estimates based on smoothed nominal and inflation-indexed Treasury yield curves and adjusted for the indexation-lag (carry) effect. Data for October 24, 2006 are preliminary. Return to text

Bottom-right panel

Alternative interpretations

- Inflation compensation remains contained and has declined of late at shorter horizons.
- Inflation compensation is above the range consistent with price stability.

Exhibit 3
Where Do You Want to Be?

This exhibit shows the results of optimal policy calculations using FRB/US. The left column is based on an inflation objective of 1½ percent, and varies the model parameters. One scenario uses the base model with policymakers assumed to place equal weight on both inflation and unemployment. A second assumes policymakers put more weight on inflation, while the third assumes that households and businesses learn about policymakers' inflation objective from the policy chosen. The right column compares outcomes based on the base model and an inflation objective of 1½ percent with those obtained if the inflation objective is raised to 2 percent. All of the charts begin in the final quarter of 2006 and run through the end of 2012.

Left panels
Optimal Policy with 1½ Percent Inflation Objective

Top-left panel
Federal funds rate

The chart shows the three paths for the nominal federal funds rate. In the base case, the funds rate rises to nearly 6 percent by late 2007, and then falls back gradually to about 3.5 percent by 2012. If policymakers put more weight on inflation outcomes, the funds rate rises further, reaching about 6.25 percent by early 2008 before falling back to about 3.5 percent by the end of 2012. With learning, the funds rate rises even more rapidly, peaking near 7 percent, but then falls back more rapidly as well, running a little below the base case by 2011.

Middle-left panel
Civilian unemployment rate

The chart shows the three paths for the unemployment rate. In the base case, the unemployment rate rises to about 5.5 percent by 2009, before falling back to about 5.3 percent by the end of the projection. With greater weight on inflation, unemployment rises to nearly 6 percent before falling back to end the period under 5.5 percent. With learning, the unemployment rate rises about as much as in the base case, but it falls more quickly, ending the period near 5 percent.

Bottom-left panel
Core PCE inflation

The chart shows the four-quarter average of the increase in Core PCE prices. In the base case, inflation falls from near 2.5 percent late this year to about 2 percent in 2009 and about 1.8 percent by 2012. With greater weight on inflation, the rate of price increase falls back to about 1.6 percent by the end of the period. And with learning, core inflation falls all the way to its 1.5 percent target by the end of 2012.

Right panels
Alternative Inflation Objectives (Equal weights)

Top-right panel

Federal funds rate

The chart shows the federal funds rate paths for the two inflation targets. The line for the 1½ percent target is the same as in the top-left panel. The funds rate path for a 2 percent target remains near 5.25 percent until late 2007, and then falls gradually to about 4 percent by 2012.

Middle-right panel
Civilian unemployment rate

The chart shows the associated unemployment rates. The line for the 1½ percent target is the same as in the middle-left panel. The unemployment rate with a 2 percent inflation target rises to a little over 5 percent over the course of 2007, and then remains at that level over the rest of the period.

Bottom-right panel
Core PCE inflation

The chart shows the core PCE inflation rates for the two inflation targets. The line for the 1½ percent target is the same as in the bottom-left panel. The inflation rate with a 2 percent target falls to a little over 2 percent by 2008, and remains near that level over the rest of the projection.

Exhibit 4
Statement Alternatives

Top panel
Rationale

[Note: In Appendix 2, Exhibit 4, Rationale, emphasis (strike-through) has been added to indicate blue strike-through text in the original document. Strong emphasis (bold) has been added to indicate normal red text in the original document.]

- In every alternative:

  Economic growth appears to have slowed further in the third quarter, partly reflecting a cooling of the housing market.

- In Alternative A:

  Readings on core inflation have been elevated, and the high levels of resource utilization ~~and of the prices of energy and other commodities have~~ **has** the potential to sustain inflation pressures.

Bottom panel
Assessment of risk

[Note: In Appendix 2, Exhibit 4, Assessment of risk, row B+ has a light-blue background in the original document.]

Alternative	Possible Effect	Target Rate	Assessment of Risk
A	Ratify expectations of easing	Unchanged	In these circumstances, future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.
B	Leave expectations about unchanged	Unchanged	Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation

Alternative	Possible Effect	Target Rate	Assessment of Risk
			and economic growth, as implied by incoming information.
B+	Emphasize tightening is more likely than easing	Unchanged	Although the Committee both seeks and expects a gradual reduction in inflation, it continues to view the risks to that outcome as remaining to the upside. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.
C	Impose additional restraint	+25 basis points	Although the Committee both seeks and expects a gradual reduction in inflation, it continues to view the risks to that outcome as remaining to the upside. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Table 1:
Alternative Language for the October FOMC Announcement

	September FOMC	Alternative A	Alternative B	Alternative C
Policy Decision	1. The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5¼ percent.	The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5¼ percent.	The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5¼ percent.	The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 5½ percent.
Rationale	2. The moderation in economic growth appears to be continuing, partly reflecting a cooling of the housing market.	Economic growth appears to have slowed further in the third quarter, partly reflecting a cooling of the housing market. Although there is a risk that the slowdown in economic growth may become more pronounced, the economy seems likely to expand at a moderate pace.	Economic growth appears to have slowed further in the third quarter, partly reflecting a cooling of the housing market. Going forward, the economy seems likely to expand at a moderate pace.	Economic growth appears to have slowed further in the third quarter, partly reflecting a cooling of the housing market. Going forward, the economy seems likely to expand at a moderate pace.
	3. Readings on core inflation have been elevated, and the high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand.	Readings on core inflation have been elevated, and the high level of resource utilization has the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand.	[Unchanged]	Readings on core inflation have been elevated and the high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures. Inflation pressures seem likely to moderate over time, but the extent and speed of that moderation is uncertain. In these circumstances, the Committee believed that an additional firming of policy was appropriate to bolster progress towards achieving price stability.

	September FOMC	Alternative A	Alternative B	Alternative C
Assessment of Risk	4. Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.	In these circumstances, future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.	[Unchanged]	Although the Committee both seeks and expects a gradual reduction in inflation, it continues to view the risks to that outcome as remaining to the upside. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

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