Conference Call of the Federal Open Market Committee on June 3, 2009

A joint conference call of the Federal Open Market Committee and Board of Governors of the Federal Reserve System was held on Wednesday, June 3, 2009, at 2:30 p.m. Those present were the following:

Mr. Bernanke, Chairman
Mr. Dudley, Vice Chairman
Ms. Duke
Mr. Evans
Mr. Kohn
Mr. Lacker
Mr. Lockhart
Mr. Tarullo
Mr. Warsh
Ms. Yellen

Mr. Bullard, Mses. Cumming and Pianalto, and Mr. Rosengren, Alternate Members of the Federal Open Market Committee

Mr. Fisher, President, Federal Reserve Bank of Dallas

Mr. Madigan, Secretary and Economist
Ms. Danker, Deputy Secretary
Mr. Luecke, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Sheets, Economist
Mr. Stockton, Economist

Messrs. Altig, Clouse, Connors, Kamin, Slifman, Sullivan, Tracy, Weinberg, and Wilcox, Associate Economists

Mr. Sack, Manager, System Open Market Account

Ms. Johnson, Secretary of the Board, Office of the Secretary, Board of Governors

Mr. Frierson, Deputy Secretary, Office of the Secretary, Board of Governors

Mr. English, Deputy Director, Division of Monetary Affairs, Board of Governors

Mr. Blanchard, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Liang, Messrs. Nelson and Reifschneider, Associate Directors, Divisions of Research and Statistics, Monetary Affairs, and Research and Statistics, respectively, Board of Governors

Mr. Oliner, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Perli, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Richards, Manager, Division of Reserve Bank Operations and Payment Systems, Board of Governors

Ms. Beattie, Assistant to the Secretary, Office of the Secretary, Board of Governors

Ms. Hinojosa and Mr. Williams, Records Management Analysts, Division of Monetary Affairs, Board of Governors

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Mr. Judd, Advisor to the President, Federal Reserve Bank of San Francisco

Ms. Mosser, Messrs. Rasche, Rolnick, Schweitzer, and Sellon, Senior Vice Presidents, Federal Reserve Banks of New York, St. Louis, Minneapolis, Cleveland, and Kansas City, respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

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CHAIRMAN BERNANKE. We have seen in recent weeks some significant increases in Treasury yields and mortgage rates.

MR. KOHN. Are you going to close the meeting?

CHAIRMAN BERNANKE. I am sorry. This is a joint FOMC–Board meeting. I need a motion to close the Board meeting.

MR. KOHN. So move.

CHAIRMAN BERNANKE. Thank you. Again, we have seen a significant rise in Treasury yields and mortgage rates, and the reason for having the meeting is just to have a bit of interaction, I hope informal, about whether any policy action is worthwhile at this stage, and whether it is or not, if we want to talk at all about how we communicate about this issue. As usual in an FOMC meeting, we are going to have a presentation from the Desk and an economic outlook update from Dave Stockton. Before doing that, we have one piece of business, which is to vote to approve the selection of Brian Sack as manager of the SOMA. Many of you know Brian, I am sure. He was here. He went off to work with Larry Meyer for a while. Now we welcome him back to the Fed family. May I have a motion?

MR. KOHN. So move.

CHAIRMAN BERNANKE. Without objection. All right. Seeing none, the motion is carried. Let me turn now to New York for a report on the Desk. Brian started yesterday, so I guess we will leave him a little more slack and go to Trish Mosser. Trish.

MS. MOSSER. You are stuck with me for one more round. Thank you very much, Mr. Chairman. In spite of the recent hiccup—a pretty big hiccup actually—in mortgage markets, financial market conditions have continued to improve for the most part in recent weeks. Most credit spreads continue to narrow, the availability of funding for financial firms has improved while the cost of that funding continues to fall, and the banks' capital-raising efforts since the release of the stress test results have exceeded expectations. Gains in both equity and commodity prices reflect a growing belief that global economic growth has stabilized, if not exactly turned the corner. In short, the perceived tail risk of a sustained free-fall in the economy, combined with another financial meltdown, has receded fairly significantly. The improvement in risky asset markets has been accompanied by significant increases in government bond yields and steeper yield curves around the globe. This, of course, includes Treasuries and has some implications for our purchase programs. Similarly, the notable improvement in funding conditions is reflected in reduced use of Fed liquidity facilities—and that's a good thing—but it affects our balance sheet.

I will talk about our programs and our balance sheet in a few moments, but let me start first with what is mostly good news. Since the April FOMC meeting, global equity markets are up 10 to 30 percent, led by particularly strong increases in emerging markets and stock prices of all types of financial firms. The improvement in the global growth outlook and the portfolio reallocation toward riskier assets is reflected in the narrowing of credit spreads nearly everywhere—with the largest declines in spreads occurring in the riskiest asset classes and the riskiest countries. Not surprisingly, the dollar has weakened notably, but in an orderly way. It's fallen about 8 percent on a trade-weighted basis since the April FOMC meeting. Generally speaking, the dollar depreciation has been largest against currencies where equity performance has been the strongest and the credit-spread tightening has been the largest. The one exception to this, which is a bit of a puzzle, is the euro, where the dollar is nearly 9 percent weaker since late April.

Turning to the United States, corporate credit spreads have tightened nearly 125 basis points for investment-grade companies and 350 basis points for high-yield companies since late April. In fact, corporate bond rates themselves have actually fallen despite the backup in Treasury yields. The largest banks continue to raise capital and issue non-FDIC guaranteed debt at a fairly fast pace, and the ease with which this capital has been raised is notable. Several of the issues have been significantly oversubscribed, and the relatively muted effect of what in many cases is very significant dilution reflects both better economic news and increased confidence in the long-term viability of the large banks.

Similarly, the spreads on most securitized products continue to narrow. Yesterday's TALF subscription supported $15½ billion of asset-backed securities, $11½ billion of which was financed in the TALF. That's 13 issues, and they covered nearly all the eligible asset classes. Indicatives, which are quoted spreads on existing consumer ABS, have continued to tighten, and the spreads on actual transactions have narrowed more than anticipated. Compared with the May TALF, the June subscription spreads are anywhere from 15 to 30 basis points narrower. For a little longer term comparison, a Ford auto loan securitization yesterday priced 130 basis points lower than a very similar issue in the inaugural March subscription of the TALF. Thinking ahead to exit—and this may be too soon—but there were several non-TALF credit card securitizations in the last week or two that were sold at spreads at or below 100 basis points. In other words, they were sold at prices that make their financing uneconomical in the TALF. The notable exception to this trend is the commercial-mortgage-backed securities market, where spreads widened very sharply last week in response to a proposed change in ratings methodology by Standard & Poor's. S&P's changes, if implemented, could result in downgrades of nearly half of the most senior CMBS tranches eligible for legacy TALF. (It would also place S&P's ratings judgments very far from its peers.) Prior to the S&P announcement, the CMBS spreads had narrowed steadily in response to the expansion of the TALF to new and then to legacy CMBS; but since the announcement, they have widened more than 100 basis points.

All the factors I noted at the last briefing have continued to push Treasury yields higher. Less macro tail risk, an unwinding of last winter's "flight to quality" investments, upward revisions to both current and future Treasury supply, and the U.S. Treasury's intentional shift of issuance out the yield curve have all contributed to an increase of nearly 65 basis points in the spread between two-year and ten-year Treasuries in recent weeks. It's worth noting that the 2-year yield hasn't budged—all of the steepening is due to an increase in the 10-year yield. The yield curve is exceptionally steep, even by the standards of past recessions. Typically, the spread between the two-year and the ten-year yield steepens steadily throughout recessions and continues to steepen into the recovery. The current spread is 270 basis points—that is above the post-recession peaks in the last few recessions and certainly much higher than previous levels late in recessionary periods in the past. In addition to the factors I've noted, a minority of market participants have interpreted this steepness as evidence of significantly increased inflation risk, but that doesn't seem to us at the Desk to be the consensus view in markets. Reduced risk of deflation and improved liquidity in the TIPS market are the most commonly cited explanations for the rise in long-dated breakeven rates. I'll repeat myself one more time by noting that the Treasury purchase program is not large enough to offset the factors that are increasing long-term yields. We continue to purchase securities at a steady pace, with purchases concentrated in the 2-year to 10-year maturity range. You won't be surprised that our operations continue to be met with very strong offers to sell securities to us.

Turning finally to mortgage markets, until the middle of last week, the effect of both the MBS and the agency purchase programs had been to narrow spreads to more-normal levels in these markets and, in the case of MBS, to encourage the refinancing wave that began in March. However, there is a clear limit to how low the Desk could and should push MBS and agency yields relative to rising Treasury rates. We don't wish to push spreads so low that we "become the market." This would not only be detrimental to market functioning but would also likely impair our ability to exit successfully when the time comes. In the MBS market, we reached that limit last Tuesday, when the MBS–Treasury spread was 130 basis points, about 10 basis points below where it had been at the time of the April FOMC meeting. On Wednesday of last week, MBS yields jumped over 40 basis points, and the 10-year Treasury yield rose 20 basis points, with most of those increases occurring in just a couple of hours during the afternoon. The proximate cause of the jump in yields was convexity hedging by mortgage servicers and originators as the primary mortgage rate rose above 5 percent—the level widely viewed as the "trigger" for households to refinance, or not refinance. But more fundamentally, the backup in MBS yields and mortgage rates was, frankly, inevitable given the steady rise in Treasury yields.

As is typical in the MBS market, once mortgage rates rose far enough that refinancing became unattractive, mortgage extension risk caused a positive feedback loop to ensue. With slower expected refinancings, the duration of existing mortgages and their associated servicing rights increased, which prompted selling of long-duration assets (MBS, swaps, and Treasuries), which in turn pushed long-term rates even higher, which caused more duration extension, more selling, and even higher long-term rates. You get the picture. By the end of Wednesday, it was clear that the spring refinancing wave that we had been experiencing was over. The mortgage convexity vortex—that's one of my favorite descriptive terms of this—has waxed and waned over the past week. There were large increases in rates on Wednesday and on Monday and modest declines in rates on other days. Regardless of the daily pattern, there is no doubt that mortgage rates have moved to a higher level, and there is likely to be additional volatility in fixed-income markets in the near term.

So what does this mean for the MBS purchase program? Except for a single day last week, we have not significantly increased our pace of purchases, nor are we planning to. To do so, we believe, would only narrow MBS–Treasury spreads to the point that other investors would leave the market. Moreover, the supply of low-coupon MBS is likely to slow significantly in coming weeks, and so over time we will shift the composition of our purchases toward higher-coupon, more-seasoned mortgages. If the rise in long-term rates persists—which it may if there continue to be macro improvements, large Treasury supply, and convexity hedging—then the new supply of MBS is likely to fall to very low levels, at which point we will consider additional tactical changes to the MBS program. We are already considering several ways to adjust both the MBS and the agency-debt purchase programs in such circumstances, and we will be reporting back to you with our findings and recommendations at the next meeting.

Finally, as Brian and I noted in the memo last week, the balance sheet has not grown as quickly as we had forecasted just a few weeks ago. Essentially, the improvement in private funding markets—evidenced by a 40 basis point decline in the three-month LIBOR rate—has accelerated the shrinkage in our liquidity facilities. As of the end of May, the liquidity facilities were $255 billion smaller than we expected a few weeks ago—mainly because of very large declines in participation in the TAF, swap-financed foreign dollar operations, and the CPFF. Figures from this week's operations suggest that the use of our liquidity facilities will continue to shrink, although perhaps not quite as rapidly as in the last few weeks. As a result, our near-term projections for the balance sheet and the monetary base have been revised down. We now expect the balance sheet to grow about 3 percent per month over the summer. We will provide more details on balance sheet projections in a couple of weeks. In the meantime, I'm happy to take any questions.

CHAIRMAN BERNANKE. Thank you very much, Trish. And thank you for many good reports. Questions for Trish? Governor Kohn.

MR. KOHN. Thank you. Trish, you noted that foreign yields went up. Compare the increase in foreign yields with the increase in U.S. yields—I am trying to get a diagnosis here. Also you said that there were upward revisions to expected Treasury supply in the last couple of weeks, and I wondered what was going on there. You said that the Treasury said it was concentrating further out the yield curve, so there might be pressure out there. But have there been upward revisions to budget deficit projections—or why the increase in Treasury supply? I wasn't aware of anything.

MS. MOSSER. This is actually over the whole last month, so it isn't just the last couple of weeks. It is really since the end of April. The April tax receipts were substantially below even the Treasury's estimates, so that has added to supply; and they are revising up the deficit projections a bit. I should have been more precise and said that the Street continues to increase their projections of Treasury supply. We know that Treasury's announcements on this are more discreet than that, but the analysts on the Street continue to increase their forecasts. The Treasury is absolutely pursuing pushing its issuance out the yield curve. It had shortened up quite substantially the weighted average maturity of the debt, and over the course of this year, it is going to be increasing the maturity of the Treasury debt pretty substantially.

Back to your first question about foreign yields, the increase in 10-year yields in the United States is slightly larger than the increases, say, in Germany and Spain. It is about 10 or 15 basis points larger than, say, in France and the United Kingdom. Japan is much smaller, only about 15 basis points. But the ranges go from about 15 basis points to about 50 or 60. The United States is toward the top, but there is no question that yields have gone up everywhere.

MR. KOHN. Thank you.

CHAIRMAN BERNANKE. President Fisher.

MR. FISHER. Trish, I also want to add my appreciation for the good reports you have been giving, particularly from someone who likes to eat the stuff up, as you know that I do. I wanted to ask you—going back to Don's question—we were talking about $2½ trillion for the fiscal year, which gives another trillion or so to run in terms of net new debt issuance. You mentioned that the Street estimates are going up. What are they talking about?

MS. MOSSER. There is a wide variety of estimates. I would like to get the Treasury staff here at the Desk to report back to you with the details. But everyone's median number keeps getting revised up. I think the range is still between $1 trillion and something over $1½ trillion. But the fact is that all of the increments to everyone's forecast are positive numbers. No one is revising things down. But we can get back to you with more details.

MR. FISHER. How far are we now into the Treasury purchase program of $300 billion?

MS. MOSSER. We are almost exactly on schedule, so we are at about $100 billion or maybe a little over $100 billion. Did I do that right? Yes.

MR. FISHER. Then, my last question is with regard to the TALF. You said the magic words "exit strategy" when you were giving your monologue. A general question: In your opinion, has the TALF been effective or marginal in alleviating some of these market pressures? Or has this just happened in conjunction with a general improvement in the marketplace?

MS. MOSSER. We think the TALF has had an important role to play in the consumer ABS markets in allowing for price discovery. When a market goes dormant for months on end, it is very difficult for investors and issuers to know what the right price is, particularly when the secondary markets are so illiquid that the prices being quoted there are just so exceptionally outside historical experience. The advantage of the TALF providing some financing has been that there is price discovery. Every time there is new issuance, that new issuance comes in just a little below the previous issuance, and the bid-asked spreads narrow just a bit. So we think that has actually been its main benefit, frankly, because the sheer size is not huge. It has been more like a kick-start mechanism for the rest of the market.

MR. FISHER. Thank you. And thanks again for your reports.

CHAIRMAN BERNANKE. Thank you. President Rosengren.

MR. ROSENGREN. Trish, can you talk a bit about the mortgage-backed security ARMs? In particular, you mentioned that the Desk was going to look at the three-, five-, and seven-year ARMs. So given that the long end has moved up so much, is there anything you are thinking of doing with the mortgage ARMs?

MS. MOSSER. Yes. As a matter of fact, that is one of the topics that we are planning to talk about at the end of the month at the in-person meeting. We are going to discuss some of the near-term strategy issues with the purchase programs, including some of the changes that we could make. And ARMs are one of the areas that we, along with the New York and Board staff, are studying. We will have probably a note for you and, if not a note, certainly a presentation on that topic.

CHAIRMAN BERNANKE. President Pianalto.

MS. PIANALTO. Trish, in your report you mentioned the potential downgrade by S&P of some of the CMBS. How is that going to affect our participation in that program? Is it going to reduce the number of CMBS that are going to be available for the TALF, and does that change any of our plans for that program?

VICE CHAIRMAN DUDLEY. I talked to the senior people from S&P this morning about this issue. What is happening is that they are changing their methodology, so the actual credit quality of the CMBS tranches that we are talking about isn't changing; it is really that they are changing how they characterize them. And we are going to have to make a decision, frankly. If their characterization is way outside what we think is appropriate, we may want to modify our criteria. For example, let's imagine a situation in which there are five rating agencies, and four rank a given tranche triple-A, and S&P is the outlier. If we really judge that the outlier is inappropriate—in other words, that there isn't a lot of credit risk associated with that tranche—we might want to change our criteria to allow one exception among the credit-rating agencies. So that is something that we are going to have to evaluate. We are going to have to see what they do and then (1) evaluate what that means for the size of the eligible market and (2) consider what it means, if we modified the criteria, in terms of what sort of credit risk we would be actually taking. So we are going to have to wait and see what they actually do in terms of what the impact is and then feed that into what is appropriate for the program. But it is not a change in their perception of the actual underlying credit quality; it is how they are characterizing that credit quality because they are changing their methodology.

MS. MOSSER. That is true.

CHAIRMAN BERNANKE. I just want to say, to be clear, that we have not made any changes. We are maintaining the triple-A requirement. So if we don't make changes, that would eliminate close to half—or something like that—of the eligible assets.

VICE CHAIRMAN DUDLEY. My point is that I think we just want to make sure that we control our own destiny. It may be completely appropriate for S&P to do these downgrades, and we may feel completely comfortable with that. We may want to rule out all of those tranches. I am just saying that it is possible that we may view them as such outliers in terms of their assessment of credit quality that we may not want to give full weight to it. So you are absolutely correct: We haven't changed our policy, and we haven't committed to changing our policy. But we might want to reevaluate that.

MS. MOSSER. One other notable difference is that with TALF 2.0 we have been fairly clear in the information we have released to the public that we are going to do much more credit analysis ourselves and we are going to hire a collateral evaluation agent to give us an independent, security-by-security evaluation of the quality of the collateral. One of the reasons for that was, frankly, concern among the team working on the TALF that we might run into a situation like this, where there were potentially significant disagreements across the rating agencies, and we really do want to have more control of our destiny, as Bill calls it. So no decisions at all have been made, and this is one of the things that the team is working on very actively.

VICE CHAIRMAN DUDLEY. Another whole issue about the question of credit rating is that, when you are talking about a new securitization selling at par, the ratings are comparable across different assets, but when you are talking about a legacy security, where the security might be selling at a very big discount to par, it is not really clear how that price and rating map into actual credit risk. In other words, if I could buy a double-A-rated CMBS that is selling at 5 cents on the dollar and then I am haircutting it on top of that, the risk I am taking is probably de minimis. So it is very important to recognize that there is a whole second set of complications when you are talking about legacy securities because a lot of these securities are not selling at par. They are selling at deep discounts to par, so a lot of the risk is already embodied in that price. But the rating agencies don't think of it that way. They are rating it as if it were an instrument trading at par, and the risk of taking actually any losses whatsoever on that.

CHAIRMAN BERNANKE. Okay. Thank you. President Bullard.

MR. BULLARD. Yes, a question for Bill Dudley. Wouldn't the other rating agencies follow suit and then change their methodology eventually, so the idea of having just one outlier maybe isn't that realistic over a medium term?

VICE CHAIRMAN DUDLEY. That is certainly possible. I think that, in our conversations with the different rating agencies, we have felt the least comfortable that S&P was up to snuff in how they rate the commercial mortgage products. So you are absolutely right. Everyone could converge to S&P's new standard—or maybe not. But at the end of the day, what we really have to think about is that this shouldn't be driven by one rating agency. It should be driven by what we are trying to do with the program and what is an acceptable level of credit risk to us. Now, obviously, the acceptable level of credit risk to us is de minimis. So I am not suggesting that we are going to be widening the program to take on a lot more risk, but I don't think we want to absolutely pre-commit ourselves to go wherever S&P drives the bus. That's all.

CHAIRMAN BERNANKE. The staff will keep working on these issues, and we will see where that goes. Anyone else, questions for Trish? Not seeing anybody, I turn now to Dave Stockton for a brief update on the outlook.

> MR. STOCKTON. Thank you, Mr. Chairman. The bottom line is that the forecast has strengthened somewhat further since the April Greenbook. The incoming data have been a little stronger than we were looking for, and there has been, on net, some continued improvement in the key factors conditioning our forecast. In the near term, the main qualitative features of the story that we have been telling for some time continue to receive support from the incoming data. Consumption looks as though it has flattened out in the first half after declining very steeply late last year. Housing looks to be stabilizing. Businesses are continuing to slash production and by enough to achieve some sizable liquidations of excess inventories. And we are still seeing capital spending decline at a pretty rapid clip.

There have been a few surprises in the data, and most of them have been to the upside. In the first quarter, with imports declining much more rapidly than exports, the contribution of net exports to GDP was larger than we had expected. And in the second quarter, we have received somewhat stronger, or maybe I should say less weak, readings on housing, equipment spending, and nonresidential construction. On that last factor, we received two months now of data on construction put in place that were much stronger than we had expected. Those surprises have been concentrated in power generation and refinery construction. We checked with the Census Bureau, and it stands by its data. But I think I can say with some confidence that we are not looking for refinery construction to be the engine of growth to propel us out of recession here. So we are not really attaching much signal going forward to any of the strength in this nonresidential construction, where we still see the fundamentals as pretty terrible.

As was the case at the April meeting, we are still not seeing any signs of appreciable improvement yet in labor markets. And I would say that the readings on the labor market, if anything, have been a bit worse than we were anticipating. Initial claims have flattened out some in recent weeks, but at very high levels. And insured unemployment has continued to soar. In fact, those data led us to mark down further our near-term labor forecast, and we are expecting this Friday’s May employment report to show a drop in private payrolls of a bit more than 500,000. I expect that that figure would be pretty close to the ADP estimate but would be 100,000 weaker than our forecast at the April meeting. And given the increase in insured unemployment, we are also expecting the unemployment rate in May to increase to 9¼ percent, and that is about ¼ percentage point higher than we had in our previous projection. Putting together the spending data, what we see in the labor market, and what we know about production, we are now estimating that real GDP declined at an annual rate of about 5½ percent in the first quarter and at about a 1 percent rate in the second quarter. Both of those figures are about ½ percentage point stronger than our April projection.

It is still the case, looking further ahead, that we think that the contraction in activity that we have experienced in the first half is going to give way to, first, a stabilization and then a modest upturn in activity in the second half. That is predicated on the expectation, which we are seeing supported in the data at this point, that final demands more broadly are going to be stabilizing in the second half, supported by fiscal stimulus and the easing that has occurred in financial conditions. And we continue to expect some lessening in the pace of inventory liquidation going forward as stocks move into better alignment with sales, and that ought to provide a boost to production as well in the second half.

As I mentioned at the outset, the key factors conditioning the longer-term forecast have shown further improvement and would lead us to revise up the projection later this year and in 2010. Stock prices are about 10 percent higher than was anticipated at the time of our April forecast, and the foreign exchange value of the dollar is down about 5 percent relative to our previous projection. As for interest rates, the backup in mortgage interest rates certainly would hold back housing some, but the quantitative effect of that increase would be offset by the decline in corporate rates that we are seeing and the decline in the corporate cost of capital. So on net, the higher stock market and the lower dollar would provide some significant impetus. That is offset only a bit by the higher oil prices, which are more than $10 a barrel higher across the forecast period. In combination with the stronger incoming data for the first half, the net effect of these changes in the conditioning assumptions would add about ½ percentage point to the growth in GDP in both 2009 and 2010. That would put us at about minus 1 percent this year and about plus 3 percent in 2010. As for our projection for the unemployment rate, as I noted earlier, despite the stronger spending data, the labor market is looking weaker to us. As a consequence, we now expect the unemployment rate to top out later this year at somewhat above 9½ percent. But then given the stronger outlook for real GDP growth over the next year and a half, we project a larger decline in the unemployment rate from that higher level, so that we would probably have a forecast of an unemployment rate a bit below 9 percent by the end of 2010, in contrast to our April forecast, which had it ending at a bit above 9 percent.

Our inflation projection will likely be revised up a bit. The incoming data on core consumer prices have been somewhat higher than we expected, but almost all of that surprise has been tobacco price increases that we just do not expect to persist. Still, we are working with higher energy prices and a lower dollar that is likely to put some upward pressure on import prices. Those are going to combine to provide a small boost, all else being equal, to core prices in both 2009 and 2010 of about a tenth or so. Obviously this year is going to get some further boost in terms of total PCE prices of about ½ percentage point from higher energy prices and a bit higher core prices. I will be happy to take questions.

CHAIRMAN BERNANKE. Thank you, David, for this intermeeting report. Questions for Dave? Vice Chairman.

VICE CHAIRMAN DUDLEY. David, where would you put the unconstrained equilibrium federal funds rate today compared with, say, the April meeting and earlier in the year? And roughly how much of that is driven just by the forecast turning out differently than we expected versus how much of that is due to the easing in financial conditions that we've seen?

MR. STOCKTON. Vice Chairman, we haven't done that calculation yet. We're just getting started. But we would be happy to do that and get it to the Committee as soon as we get a little better fix on tying down the forecast at this point.

VICE CHAIRMAN DUDLEY. Okay.

CHAIRMAN BERNANKE. Other questions? President Lockhart.

MR. LOCKHART. Yes, thank you, Mr. Chairman. Dave, on the question of risks to your outlook, there has been a lot of discussion of commercial real estate. Can you give some sense of how you would quantify any risk to the outlook associated with worse-than-expected problems in the commercial real estate sector?

MR. STOCKTON. Luckily that sector is a small enough share of total GDP that, even with an appreciable error on our part to the downside, there would not be a whole lot of direct effect on GDP. Nevertheless, it is still the case that the fundamentals there look extremely soft, and aside from the power generation and refinery surprises that we have had, the rest of commercial real estate is coming pretty close to our expectations in the forecast. It is easy to see how we could have a sharper decline there than we have built into the forecast. But I do not think we would be looking at something that did more than affect the top-line GDP by a tenth or two, even if we were to see a more significant decline. Now, whether or not there would be feedback effects through the financial system of a continued deterioration in commercial real estate and sharper price declines there, I think that would probably be the bigger concern. And if I were more concerned about the downside risk to the outlook, I would look for effects probably coming through that channel rather than through the direct construction channel alone.

CHAIRMAN BERNANKE. Other questions? Okay. Let me make just a couple of comments about the situation, and then we'll open it up for any questions or comments that participants may have. Looking at the increase in yields, it is not an entirely benign development, obviously. There is the undercurrent of huge deficits, and on a few specific days, like the day on which the United Kingdom got the warning, we saw a bad combination of movements: a decline in the dollar, a rise in yields, and a fall in equity prices, which is sort of indicative of a flight from U.S. debt. So a couple of days like that were somewhat worrisome.

Having said that, my own view—and I will want to hear views of others and from the staff—is that most of what we have seen since the FOMC meeting is the result of more-positive influences, notably, first, the better outlook, which has caused the term premium to increase or the yield curve to steepen, and second, the reversal in the flight to quality. We are seeing the dollar decline and the yields rise at the same time that equity prices go up, which suggests a more positive interpretation of the development. It is not clear what role inflation expectations are playing. It is certainly true that, mechanically, a significant part of the increase is tied to the increase in 5- to 10-year breakevens. But whether that is really a change in inflation expectations arising, say, from reduced fear of deflation or whether it's just better operation and more liquidity in the TIPS market is not entirely clear. But either one, I think, is not particularly worrisome because the breakevens now suggest a still well-controlled rate of inflation, pretty close to what our target would be. So I guess my overall assessment is that, although we need to watch carefully in terms of the risks associated with flight from the dollar or flight from Treasuries, that this is mostly a benign development. Based on that, if I were recommending at this point, I would not recommend any change in our policy. To the extent that this increase in yields is being driven by a better outlook that is an endogenous part of the improvement of the economy, I think our best approach there would just be to wait and watch and see how things go.

I would also mention, as I did in my note to the Committee earlier, that I think that June's meeting is going to be very informative. We have presentations in June on a wide variety of aspects of our program, including the effects of large-scale asset purchases; as Trish mentioned, the tactics of making purchases; the exit strategy both from individual programs and from the balance sheet; and managing the balance sheet more broadly. So I personally would think that we would want to wait and hear more about those issues, particularly the exit strategy, before making any changes in our programs.

On communication, my suggestion would be, to the extent that you agree that this is primarily a benign development, that we communicate that we are comfortable, that we are taking a wait-and-see approach, and that we will just review as necessary our policies as the data come in. That would be the summary of my own view at this point, but if others disagree or want to amplify, I certainly would be happy and interested to hear that. So are there any questions or comments? President Lacker.

MR. LACKER. Thank you, Mr. Chairman. I did suggest that this be a formal FOMC meeting to you in conversation last Friday. I did this for three reasons. One, to make sure we would be able to elect Brian Sack as soon as possible. Second, the staff noted that the change in the monetary base projections or the balance sheet or however you look at it was going to be substantially different from what they had told us they would expect, given our plans coming out of the last meeting. And I think in light of our uncertainty about just how transmission mechanisms are working right now, a little consultation was warranted even if one's expectation coming into this might not be that recalibrating or recrafting our plans was warranted. My own sense—I agree with you, Mr. Chairman—is that we shouldn't alter our purchase programs right now. Maybe we view that as warranted at the next meeting, but I do not at this meeting want to suggest that we ought to change our purchase programs, even though the trajectory for the balance sheet seems significantly lower. The third reason I wanted to suggest that this would be a fruitful discussion had to do with the Treasury market selloffs that occurred over the last couple of weeks, which you alluded to and Trish Mosser and others have talked about. One notable feature of those selloffs is that they at times were accompanied by substantial market chatter about the possibility that we might intervene or increase our purchase programs in order to limit yield increases.

Now, this highlights for me a communication challenge that I think we are likely to face several times again. We have embarked on an asset-purchase program of a certain size, and we didn’t discuss much how program size could or would or should or ought to vary with circumstances. Even though there is language in the directive that says it ought to vary with circumstances, we didn’t really talk about the way in which it ought to change with evolving circumstances. That language is in the directive. So you can see how the private sector might have been encouraged to think that, if we get surprised by something, we might react by changing our purchase programs. I think that market participants believe about our programs that we want to lower borrowing costs and to lower them in particular markets like mortgages, credit cards, or auto loans. And that connection, which I think has been made in a lot of market participants’ minds, would lead naturally to the supposition that we want to reduce yields on things like Treasuries and mortgage-backed securities. From there it is just a short step to the notion that we might react to unexpected increases in yields with an expansion of our purchase program.

But as you pointed out, Mr. Chairman, there are a lot of reasons that yields could increase in ways that wouldn’t imply that we would have a motive to increase purchases. In fact, some of these reasons, if anything, would imply that we might want to consider backing off or reducing the scale of our purchases. Better growth prospects, for example, indicate perhaps a reduced need for stimulus. Higher expected inflation or reduced probability attached to the possibility of deflation would seem to suggest reduced stimulus. Higher federal deficits—again, if we were to increase our purchases, that would amount to sort of monetizing the debt. Or if we were to try to offset the effect of higher deficits on yields, that would amount essentially to monetizing some of the debt, which would be inflationary. I do not think we want to do that.

To my mind, this arises in part because of the degree to which we have emphasized the asset side of our balance sheet rather than the liability side. The way I have communicated about our stimulus and our asset purchases is to refer to them generally in terms of the overall stimulus that the programs are supplying. So in the weeks ahead and maybe even the months ahead, when we get to episodes in which yields change in an unexpected way and people are talking about how we are going to react, my own view is that articulating this in terms of the overall stimulus we are providing and de-emphasizing borrowing costs and interest rates in particular market segments might be useful. In addition, sort of in conjunction with that, it might be useful to emphasize other developments that could be affecting yields for plausible reasons that would obviously not warrant an increase in stimulus—improving credit market conditions, reduced downside risks to inflation, and so on.

So those are just the remarks I have, but again, it was out of a concern that recent market events and commentary on them seemed to indicate some uncertainty and confusion about our potential reaction function—in this case, thinking of our reaction function as being asset purchases as a function of incoming information, like yields. I was just struck by the extent to which markets put some probability on the notion that we might increase the scale of our intervention to try to damp the increase in yields, which I think in this case would be pretty clearly the wrong thing to do. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you, President Lacker. You raise some interesting points. In testimony and other contexts, I have said a couple of times that we weren't trying to defend any particular interest rate, which I think is appropriate given that, as you point out, interest rates can change for different reasons. So I think that your point is well taken. Other questions or comments? All right. If there is no other discussion, I appreciate the opportunity to talk a bit about these issues. Clearly, there is a lot more that we are going to learn between now and a couple of weeks from now, and in particular, we do have a very full program of staff materials about various aspects of this. I hope that we are going to show some "learning by doing" here and that, as we go forward, we will refine our tactics and our strategy; and having this input is very helpful.

I would like to just mention to you that Debbie is pointing out to me that everyone has now agreed with the proposed schedule of 2010 FOMC meetings, and so if there are no objections, we are going to release that schedule to the public at the end of this week. Anything else? Okay. Thank you very much for your time, and we will see you in Washington in a few weeks, if not sooner. Thank you.

END OF MEETING