Risk Management in Monetary Policymaking

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March 5, 2019
The fourth quarter of 2018 featured significant volatility:
- Domestic and international stocks fell
- Stock volatility rose
- Oil prices fell
- Treasury rates fell
- Credit spreads widened
- Caused some analysts to highlight higher recession probabilities

Since the start of 2019:
- Many financial markets have recovered
- A budget agreement avoided an extended government shutdown

Significant risks remain unresolved:
- Slowing in China and Europe
- Possible trade issues
- Potential for messy Brexit
- Problems at some European banks
Baseline outlook remains relatively good
  - Expect economic growth somewhat above 2 percent
  - Expect inflation to end 2019 close to 2 percent target
  - Labor markets likely to tighten somewhat further

Still downside risks
  - Economy slowing from nearly 3 percent last year
    - Diminishing fiscal stimulus
    - Effects of four increases in short-term rates
  - Risk that slowdown in rest of world could dampen U.S. growth more than currently expecting

Overheating risks seem less pressing at this juncture
  - Financial market volatility has tempered investor ebullience
  - Inflation currently a little below the Federal Reserve’s target
Implications for Monetary Policy

- Federal Reserve should remain patient
  - Expect reasonably strong economy
  - Overheating not an immediate problem; inflation well behaved
  - Evaluate if downside risks become more acute

- Monetary policy is currently appropriate given balance of risks
Figure 1: U.S. Stock Price Indices
January 5, 2018 - March 1, 2019

Note: Index level January 5, 2018=100. Weekly averages.
Source: DJ, S&P, WSJ, Haver Analytics
Figure 2: International Stock Price Indices
January 5, 2018 - March 1, 2019

Note: Index level January 5, 2018=100. Weekly averages.
Source: S&P, FT, STOXX, Bloomberg Finance L.P., Haver Analytics
Figure 3: CBOE Market Volatility Index (VIX)
January 5, 2018 - March 1, 2019

Note: Weekly averages.
Source: CBOE, WSJ, Haver Analytics
Figure 4: Ten-Year Treasury Yield  
January 5, 2018 - March 1, 2019

Note: Weekly averages.  
Source: Federal Reserve Board, Haver Analytics
Figure 5: Long-Term Yield Spread and Near-Term Forward Spread
January 5, 2018 - March 1, 2019


Source: Federal Reserve Board, Haver Analytics
Figure 6: High-Yield Corporate Bond Spread over Ten-Year U.S. Treasury Yield
January 5, 2018 - March 1, 2019

Note: Weekly averages.
Source: ICE/BofA Merrill Lynch, Federal Reserve Board, Haver Analytics
Figure 7: Ten-Year Government Bond Yields
January 5, 2018 - March 1, 2019

Note: Weekly averages.
Source: Reuters, Haver Analytics
Markets Still Pricing In Somewhat Elevated Risk

- Domestic stocks have partially recovered and volatility is lower
- Foreign stocks and debt markets still reflective of downside risks
- These heightened risks are an important reason for policy patience
Figure 8: Blue Chip Forecast for Real GDP Growth
2019:Q1 - 2019:Q4

Quarterly Percent Change at Annual Rate

- Average of 10 Highest
- Consensus Forecast (Average)
- Average of 10 Lowest

Source: Blue Chip Economic Indicators, February 10, 2019
Figure 9: Unemployment Rate by Race and Ethnicity
January 2009 - January 2019

Note: Persons whose ethnicity is identified as Hispanic or Latino may be of any race.
Source: BLS, Haver Analytics
Figure 10: Initial Claims for Unemployment Insurance
January 3, 2009 - February 23, 2019

Note: Four-week moving average.
Source: U.S. Department of Labor, Haver Analytics
Note: The quits rate is the number of quits during the entire month as a percent of total employment. Pictured above is the three-month moving average.

Source: BLS, Haver Analytics
Figure 12: Wage Growth for Private Industry Workers
2009:Q1 - 2018:Q4

Source: BLS, Haver Analytics
Figure 13: Employment Cost Index: Wages and Salaries for Private Industry Workers in Selected Industries
2009:Q1 - 2018:Q4

Source: BLS, Haver Analytics
Figure 14: Inflation Rate: Change in Personal Consumption Expenditures (PCE) Price Indices
January 2009 - December 2018

Note: Core PCE excludes food and energy.
Source: BEA, Haver Analytics
Figure 15: Inflation Rate: Change in Personal Consumption Expenditures (PCE) Price Indices for Goods and Services
January 2009 - December 2018

Source: BEA, Haver Analytics
Concluding Observations

- Modal forecast still favorable for growth, inflation, and labor markets
  - Financial markets have improved from the end of last year
  - Little evidence of overheating

- Downside risks to that outlook have increased, and still seem elevated
  - Weak December retail sales among signs that economy may be slowing more than anticipated
  - Some mark-down in private-sector forecasts for first quarter
  - Downside risks reflected in markets, especially foreign stocks and all debt markets

- Monetary policy should be patient
  - Data still delayed from government shutdown
  - It may be several FOMC meetings before policymakers have a clearer read on whether risks become a reality
  - Fortunately, with less ebullience in financial markets and no immediate signs of inflation, patience is prudent