FEDERAL RESERVE BANK OF BOSTON™

Monetary Policy and Financial Stability

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Economy Improving Slowly

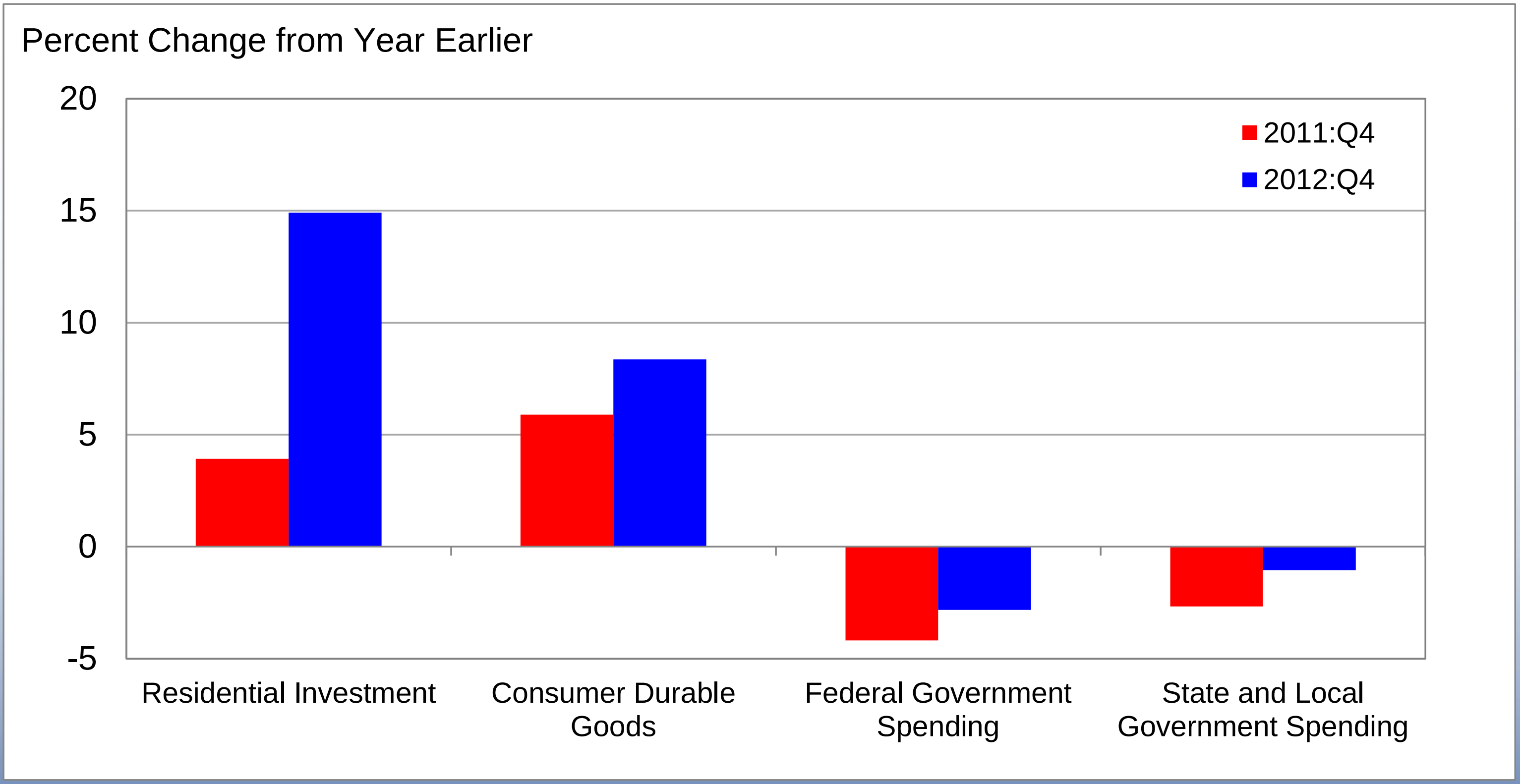
- Despite headwinds – problems in Europe and more fiscal austerity in the U.S. than many expected – the economy is slowly improving
- Large-scale asset purchases (LSAPs) have helped interest-sensitive sectors and are helping to offset fiscal headwinds
- With unemployment at 7.7 percent and PCE inflation at 1.2 percent, the economy remains far from where we want it to be

Preview

- Despite benefits of LSAPs, how large are the costs?
- Inflation remains low, and that is expected to continue
- Financial stability – need to monitor closely, but seeing little evidence that monetary policy is causing significant financial stability problems at this time
- In short, benefits currently outweigh costs

Figure 1
Growth in Real GDP Components

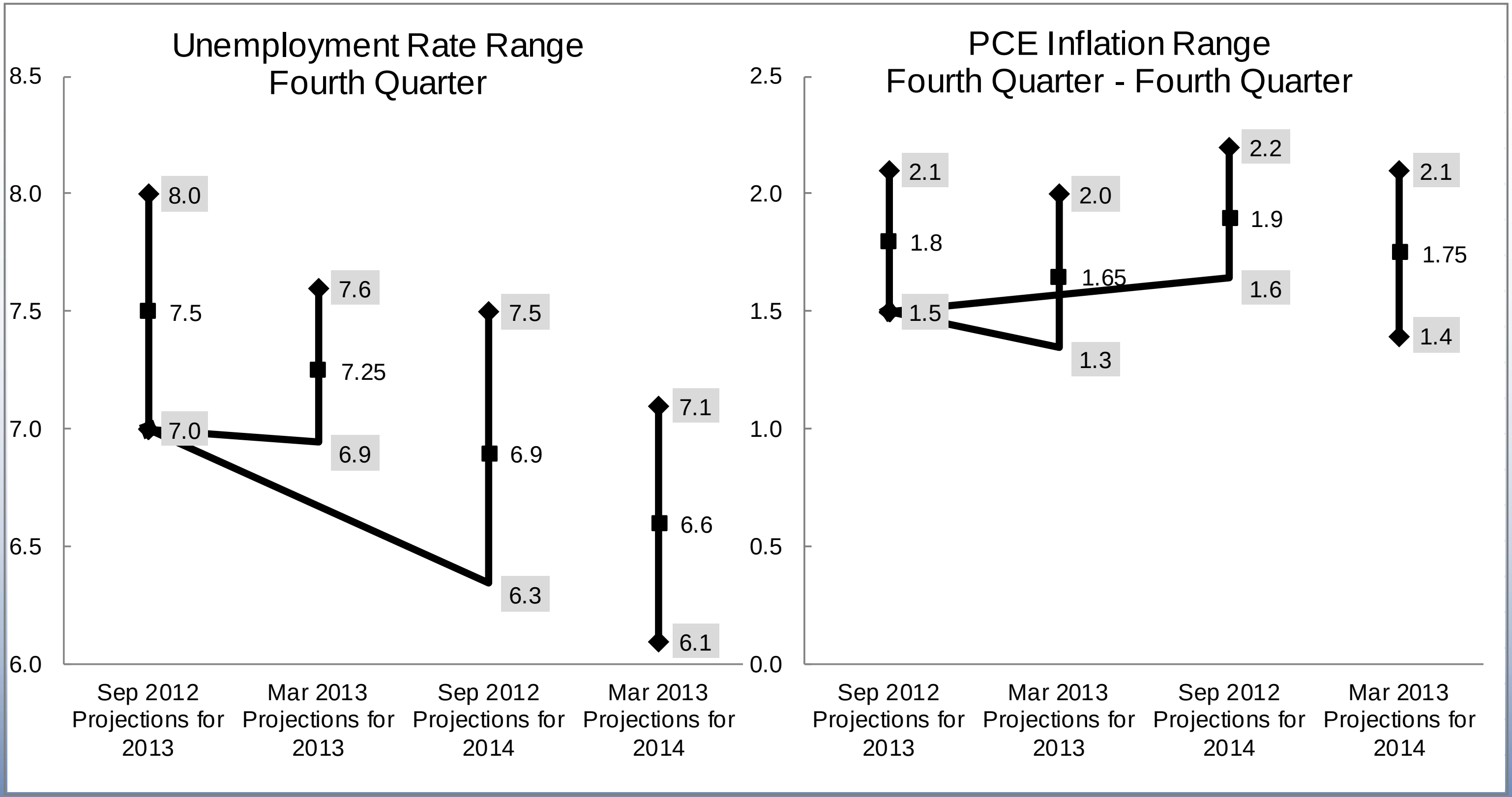
2011 and 2012



Source: BEA / Haver Analytics

Figure 2
Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents

September 2012 and March 2013



Source: Federal Reserve Board

Benefits of LSAPs

- Help reduce longer-term rates – promote economic growth and more quickly return to full employment with stable prices
- FRB Boston uses two models – one structural, one statistical
- Both imply roughly $500 billion in asset purchases result in one-quarter point reduction in unemployment – almost 400,000 jobs
- Estimate is model dependent, subject to estimation error

Potential Cost: Inflation

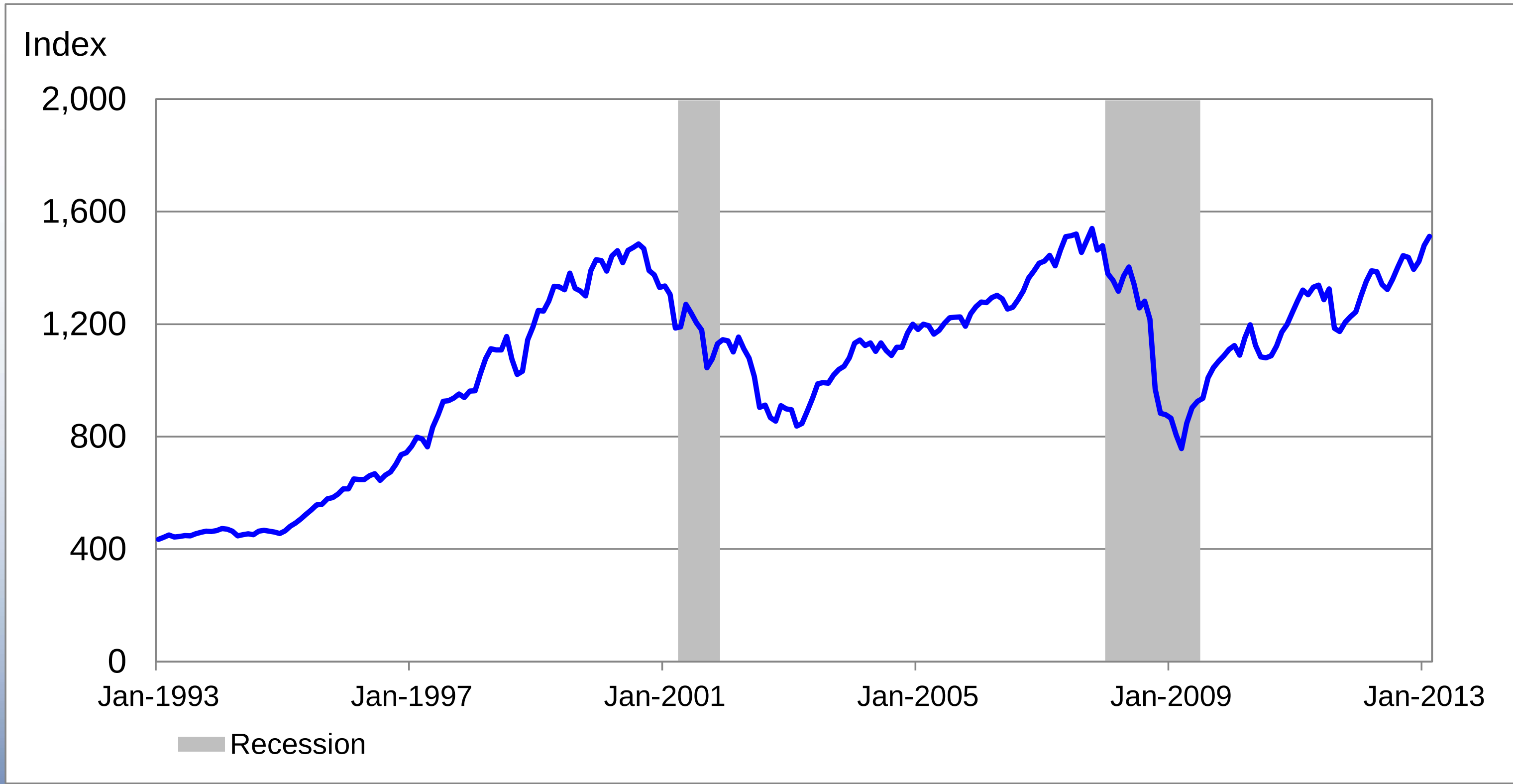
- Potential that inflation or inflation expectations could rise too quickly
- Federal Reserve balance sheet expanded significantly in 2008, and almost five years later, PCE inflation is 1.2 percent – well below 2 percent target
- This provides the Fed the ability to take monetary policy actions to encourage stronger growth

Potential Costs: Financial Instability

- Potential that interest rates at zero lower bound may induce investors to take on excessive risk
  - Too much credit risk
  - Too much interest rate risk
- Intent of policy, in part, is to encourage households and firms to not be excessively risk averse – i.e., to encourage responsible risk-taking that advances real economic activity and growth

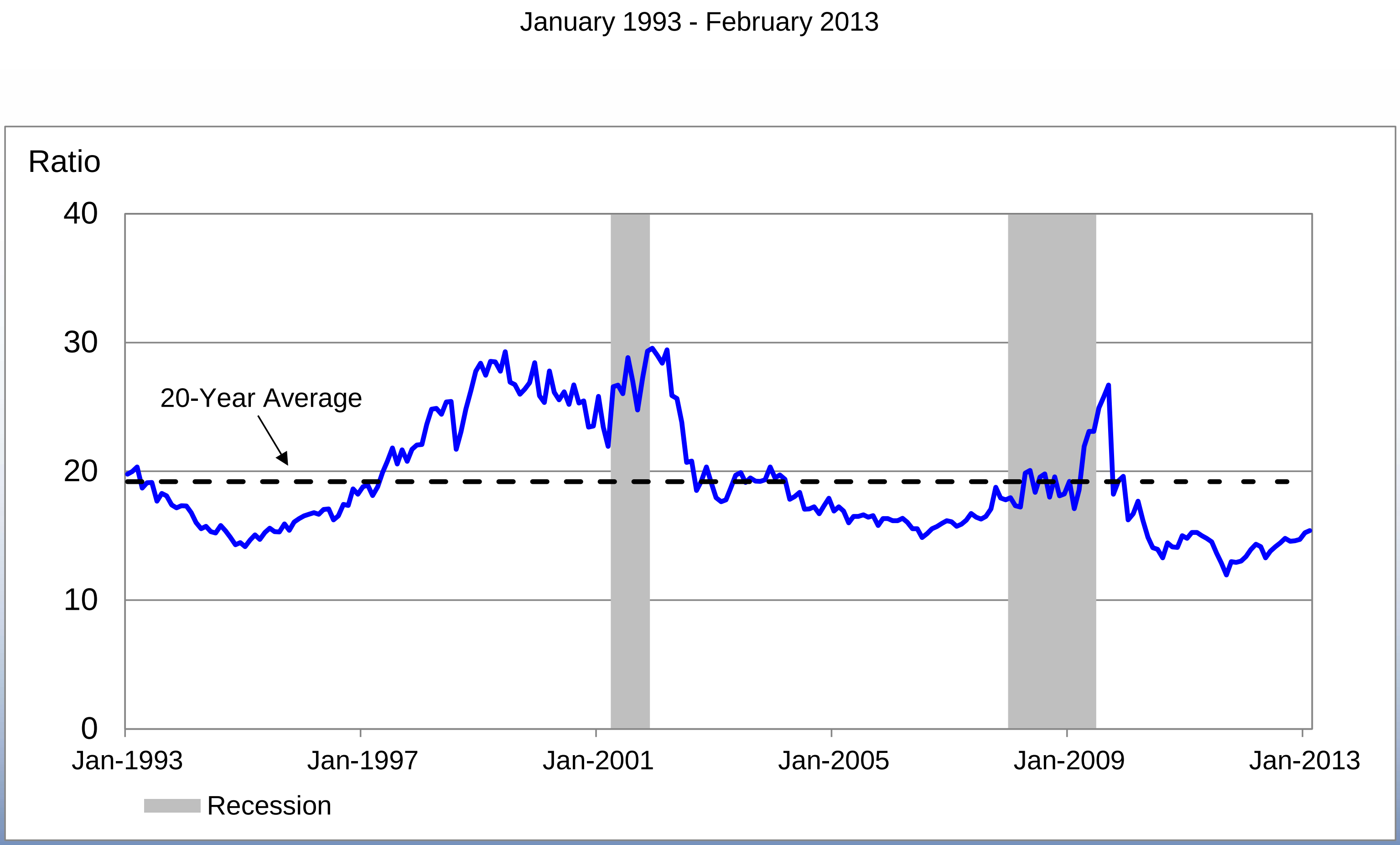
Figure 3
S&P 500 Composite Stock Price Index

January 1993 - February 2013



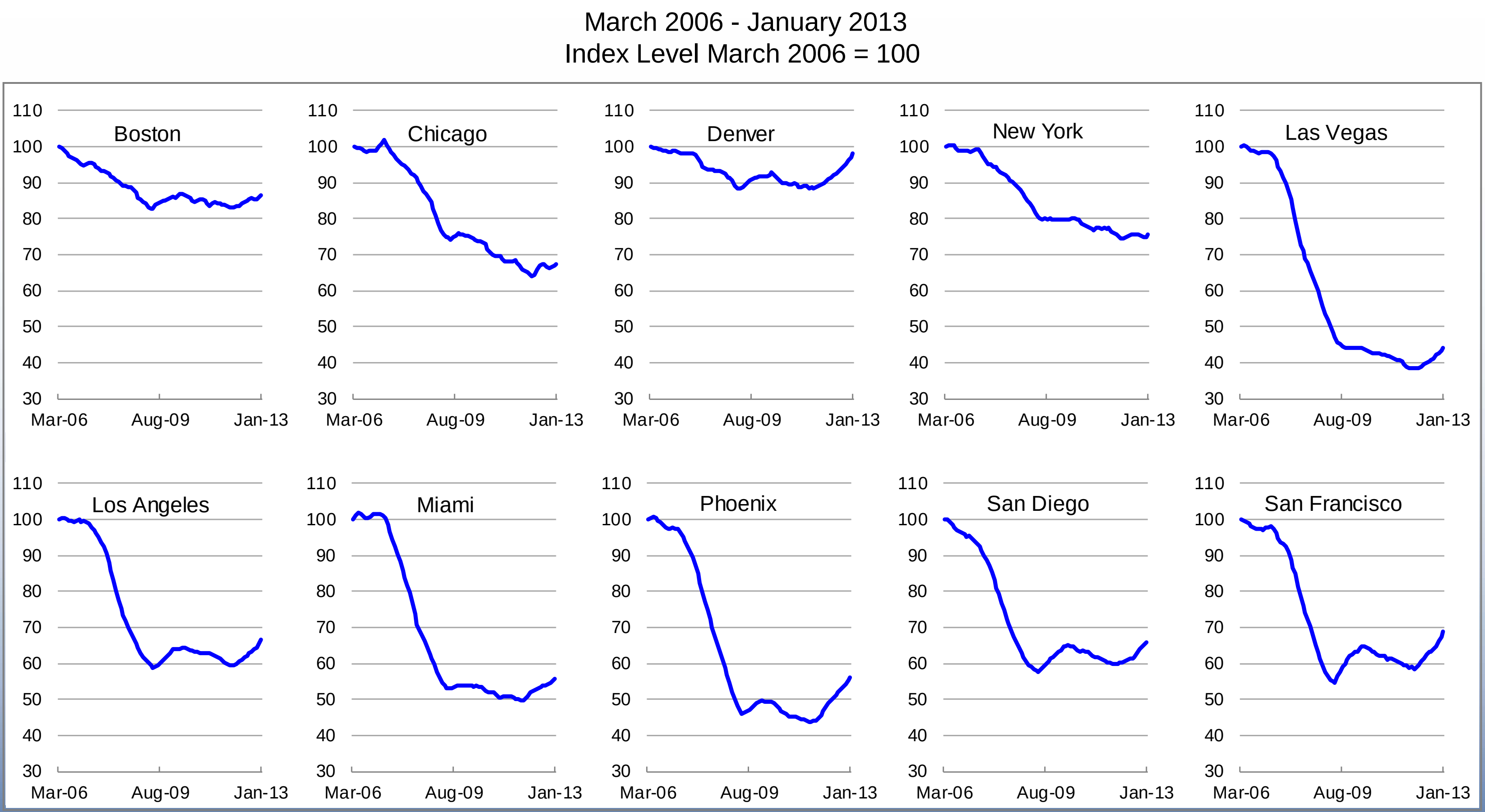
Source: S&P, NBER / Haver Analytics

Figure 4
S&P 500 Composite Price/Operating Earnings Ratio



Source: S&P, NBER / Haver Analytics

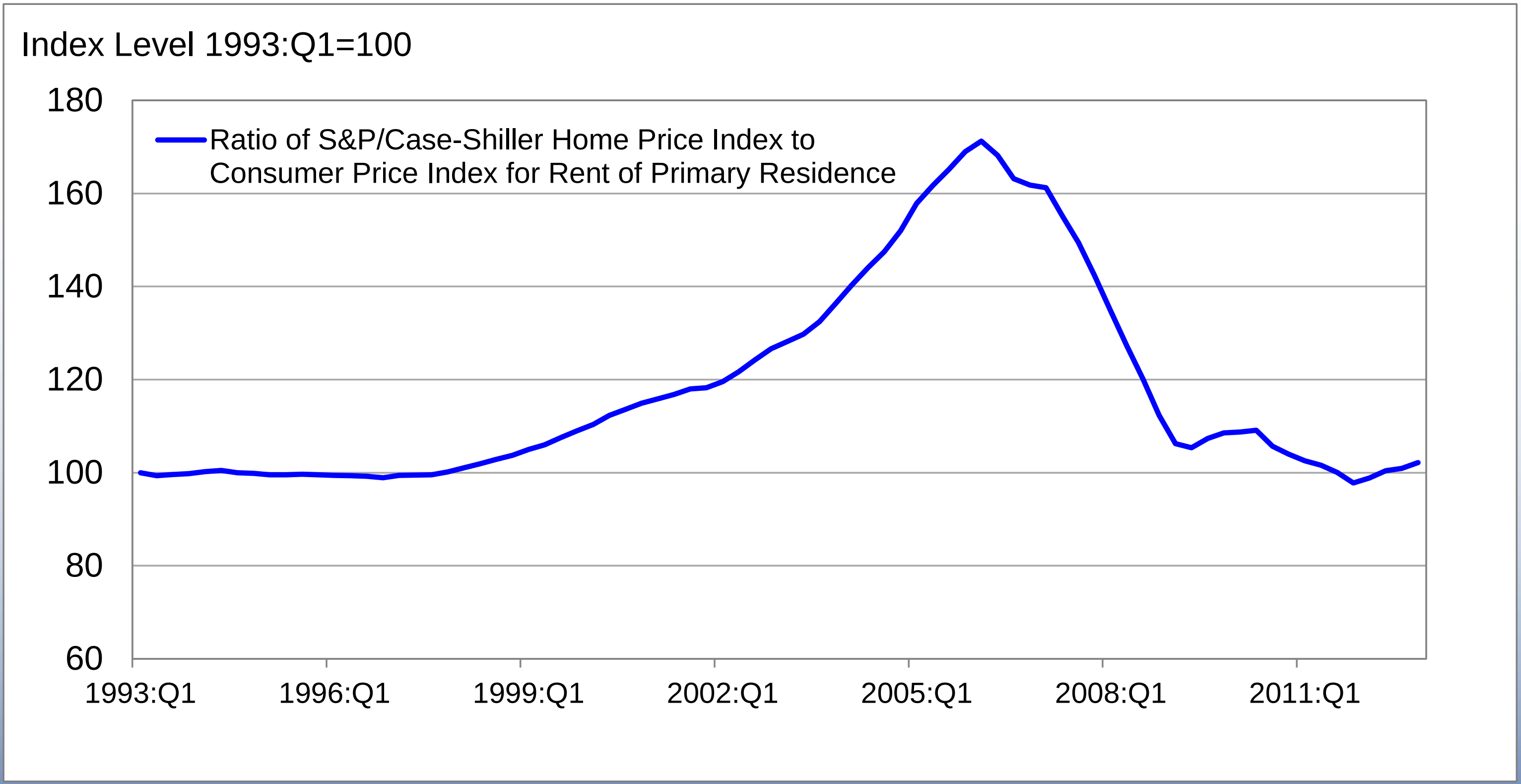
Figure 5
U.S. Regional Home Prices: S&P/Case-Shiller Metro Area Indexes



Source: S&P/Case-Shiller / Haver Analytics

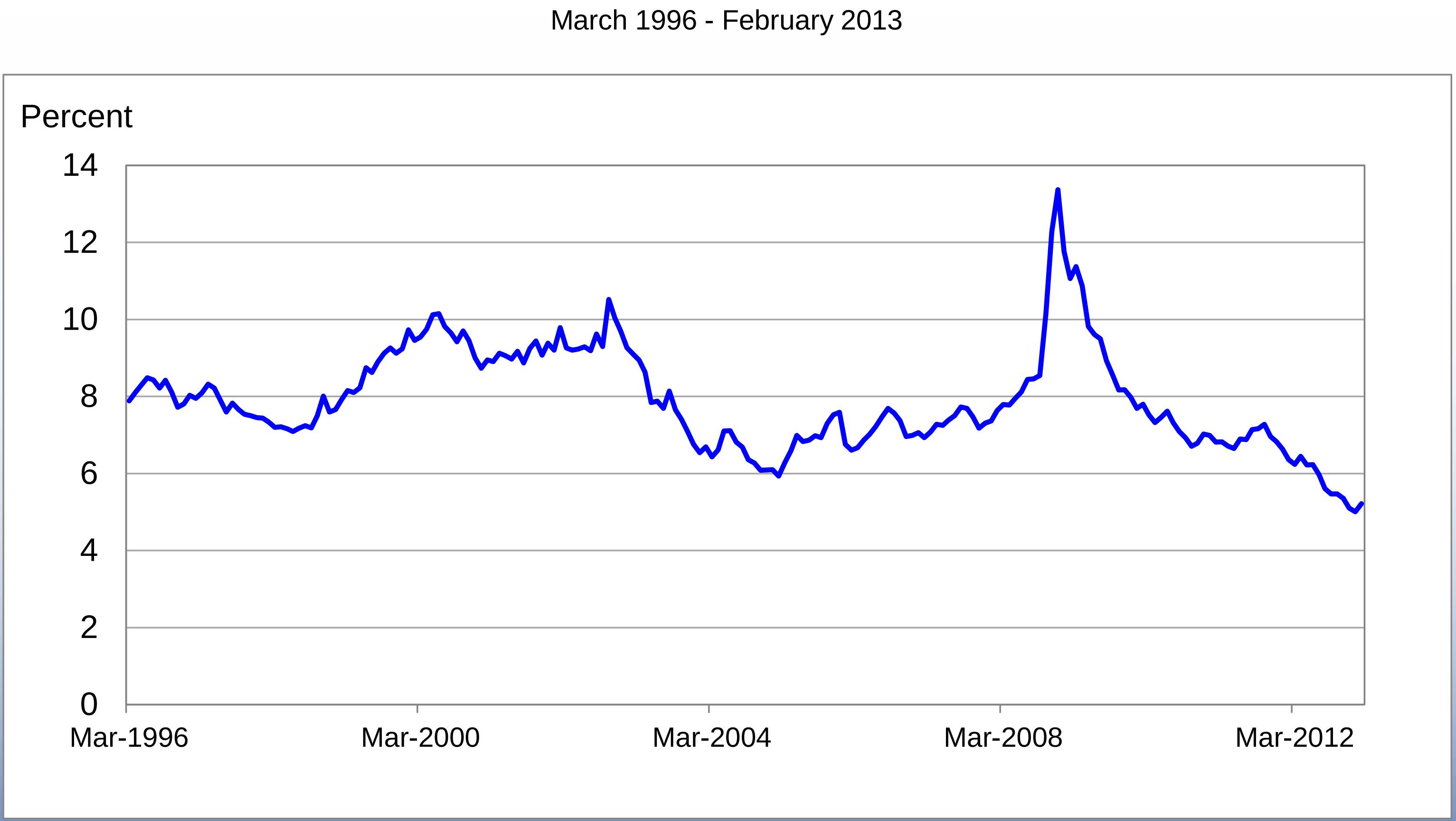
Figure 6
Price-to-Rent Ratio

1993:Q1 - 2012:Q4



Source: S&P/Case-Shiller, BLS / Haver Analytics

Figure 7
High-Yield Bonds:
S&P 10-Year BB+ Industrials Bond Yield

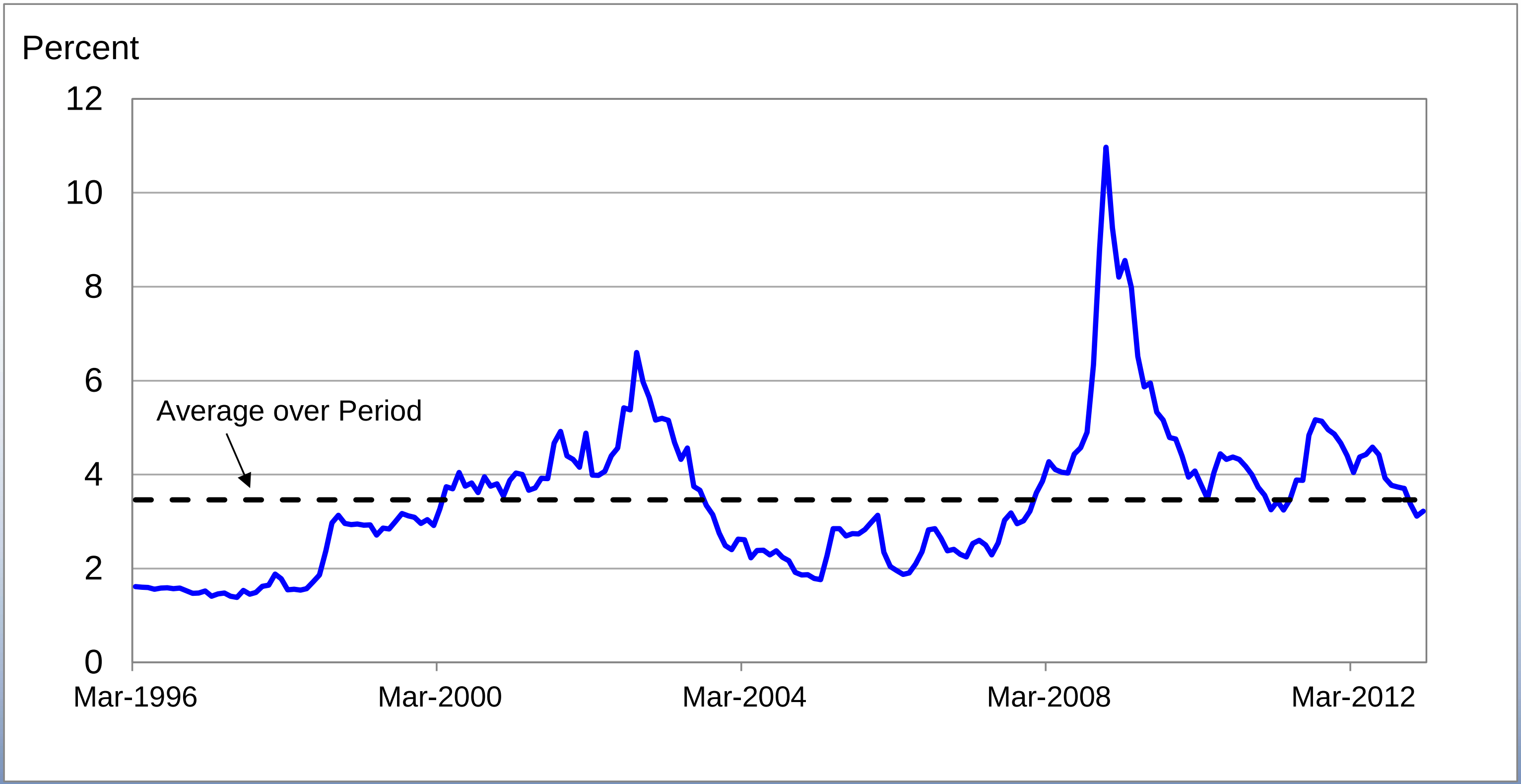


Source: S&P / Haver Analytics

Figure 8

High-Yield Bond Spread: S&P 10-Year BB+ Industrials Bond Yield to 10-Year U.S. Treasury Yield

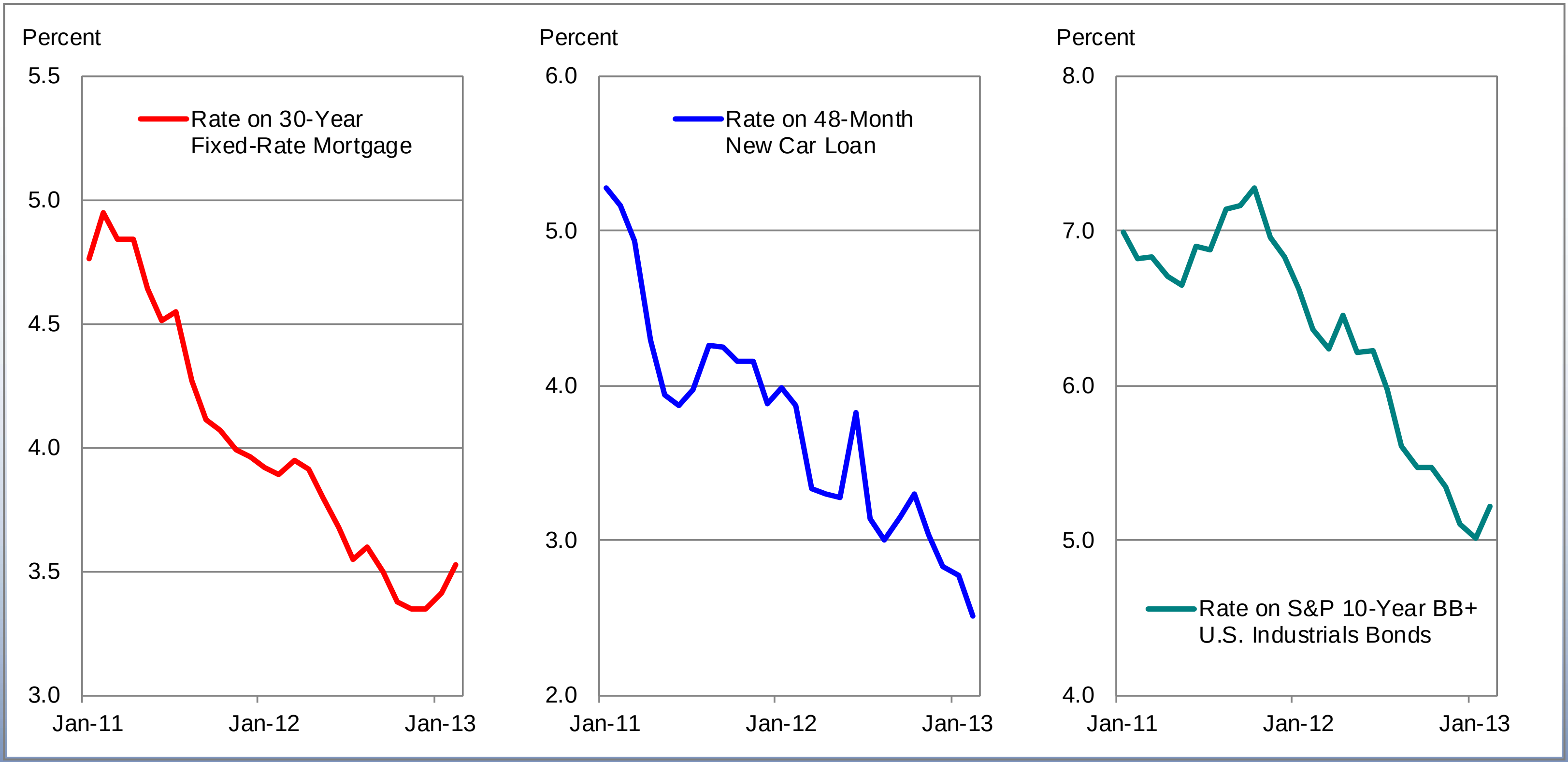
March 1996 - February 2013



Source: S&P, Federal Reserve Board / Haver Analytics

Figure 9
Rates on Mortgage Loans, Auto Loans, and High-Yield Bonds

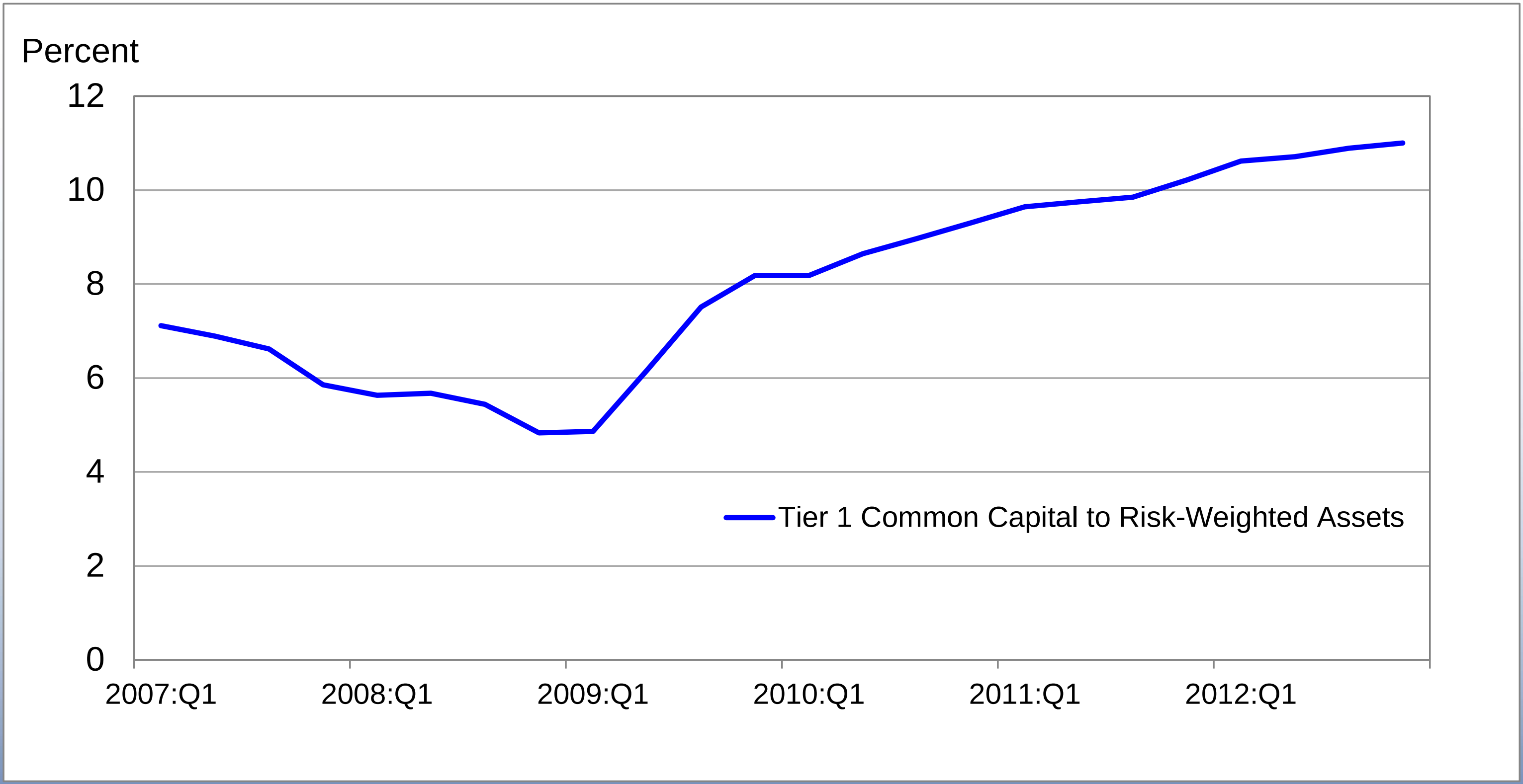
January 2011 - February 2013



Source: FHLMC, WSJ, S&P / Haver Analytics

Figure 10
Tier 1 Common Capital Ratio for Large U.S. Banking Organizations

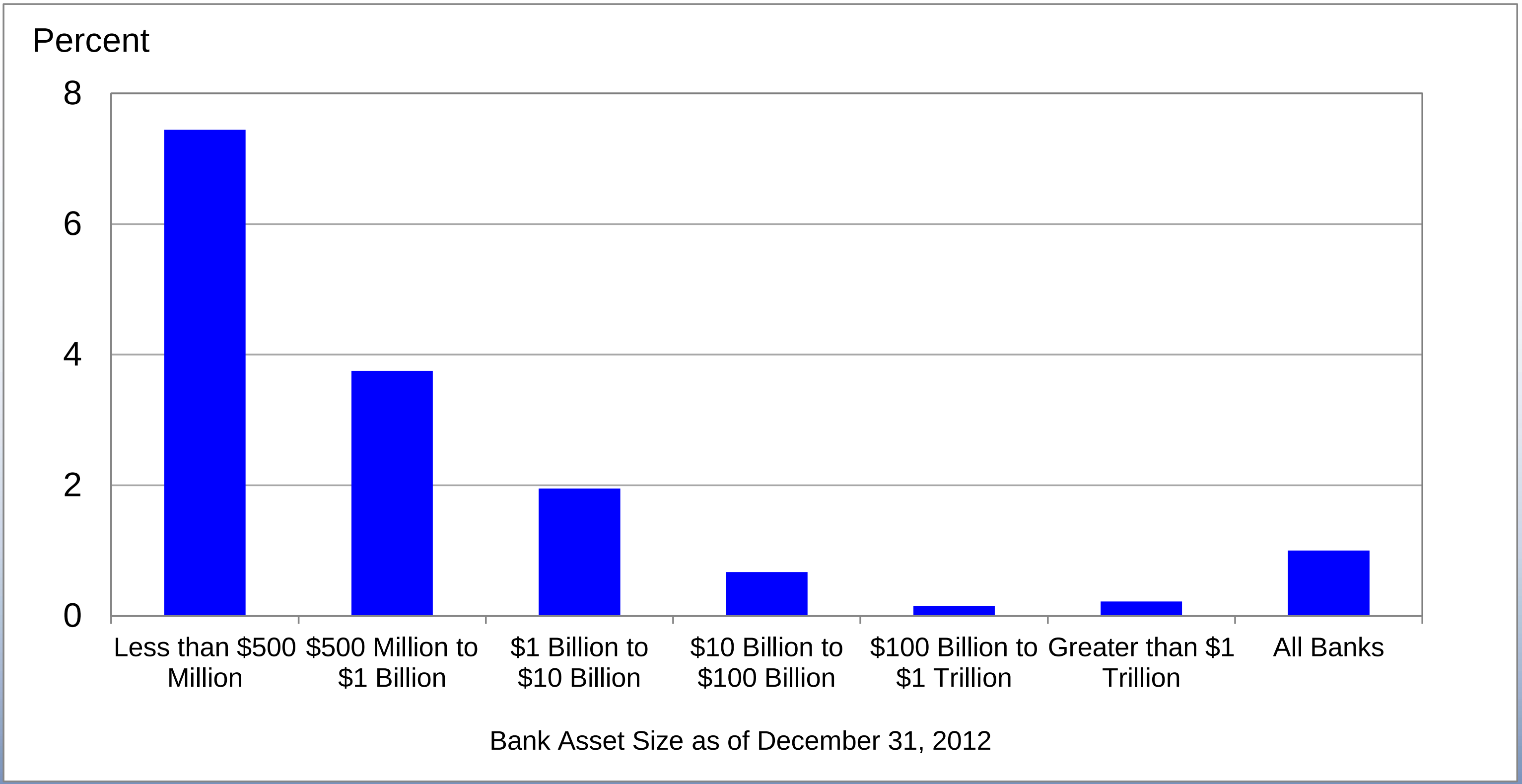
2007:Q1 - 2012:Q4



Note: Includes 14 large banking organizations that filed the FR Y-9C throughout the six-year period
Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C)

Figure 11
Agriculture-Related Loans as a Share of Assets at Commercial and Savings Banks by Asset Size

December 31, 2012



Note: Includes agricultural production loans and real estate loans secured by farmland
Source: Commercial and Savings Bank Quarterly Call Reports

Risks Seem Manageable

- Broad-based financial stability concerns do not seem acute at this time
- Falling interest rates and rising asset prices are expected results of the policy
- With improvement in economic outlook, accommodation can be withdrawn
- Nonetheless, financial stability concerns need to be monitored

Areas to Monitor Closely

- Underwriting standards – decline in covenant quality for leveraged loans and high-yield bonds
- Short-term borrowing to finance long-term assets – e.g., agency REITS
- Run risks exposed in financial crisis and not yet resolved – e.g., MMMFs, reliance on wholesale funding, broker-dealers

Concluding Observations

- The economy continues to improve, but at a painfully slow pace
- Benefits of Fed policy actions are clear from improvement in interest-sensitive sectors
- Need to monitor for potential financial stability problems – but at this time the benefits of our programs outweigh the costs