The outlook and current topics in monetary policy

Emerging Leaders in New England’s Banking Industry
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What’s the Fed up to?

- Raising rates?
- Raising rates more this year? Next?
- If so, why?
- Are there risks to keeping rates too low?
Is the Fed raising rates? So far, yes

- Three increases so far. Diversity of opinion about the future…

Target funds rate (end of month)

Funds rate probabilities

- Probability of 1.0 - 1.25 or greater
- Probability of 1.25-1.5 or greater

Source: FRB H.15 release (funds rate), Board of Governors of the Federal Reserve System, CME FedWatch tool (funds rate probabilities)
Our responsibilities

- The “Dual Mandate”: low inflation, maximum (sustainable) employment

- Where are we in achieving these goals? First, employment:

![Graph showing labor market slack and employment growth](image)

**Measures of labor market slack**

- Civilian unemployment rate
- "U-6" (broader measure of unemployment (right scale))

**Employment growth**

- Total
- Private

Wage growth has accelerated:
- AHE: 2.5% (12-mo. chg.)
- NFC: 3.9% (4-qtr. chg.)

Sources: Bureau of Labor Statistics (unemployment, employment, AHE wage growth, nonfarm compensation), Haver Analytics
Why are they raising rates?

- **Inflation**: What’s our goal? 2%
- How close are we?
  - Pretty close
- Some of these movements are likely temporary
  - Increases, decreases in energy, import prices—and cell phone prices!
- We are OK with modest deviations on either side of 2%

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**PCE inflation, 12-mo. % change**

Fed’s inflation goal = 2%

Sources: Bureau of Economic Analysis, Haver Analytics
Do we need to get there right away?

- No, we can do this gradually
- Compare the “SEP” chart to previous episodes:
- Note:
  - Much slower
  - Much lower
- But gradual does not mean 1x per year, at Christmas

 sources: FRB H.15 release, Haver Analytics
Two main risks to low rates

- They lead to economic instability
  - A very low unemployment rate has always been followed by a very high one

- They may lead to financial instability
  - Many talk about “reaching for yield”
  - The idea is that when low-risk yields are low, folks look for higher yields, which necessarily entails taking on higher risk
  - Signs of this today?
Risks to economic stability

- This chart almost speaks for itself.
- In every episode post World War II, unemployment slipping too far below normal leads to a recession.
- We’d prefer a stable, sustained recovery.

Sources: Bureau of Labor Statistics (unemployment rate), Congressional Budget Office (natural rate of unemployment), Haver Analytics.
Weaker growth than expected in the first quarter

- Inventories subtracted almost one percentage point
- Consumer spending grew by less than 0.5%
  - Warm weather, delayed tax refunds, poor seasonal adjustment
- But underlying supports—income, wealth, sentiment—are good

So I expect a rebound for the rest of the year, to an average of a bit greater than 2%

Sources: Bureau of Economic Analysis (GDP and its components), Haver Analytics
A closer look at transitory factors

- **Autos**
  - Still at a very high rate
  - Energy services
  - Mild weather in Q1

- **Inventories**

Sources: Bureau of Economic Analysis (Inventories and weather services), U. of Michigan SRC (sentiment), Autodata corporation (auto sales), Haver Analytics
Some Fed balance sheet issues
It’s big.

Federal Reserve Assets (partial)

Agency and MBS
Treasuries

Sources: Federal Reserve H.4.1 release, Haver Analytics
Why reduce the balance sheet size?

When?

- Our holdings of securities are still exerting downward pressure on long-term rates
  - As part of normalization, reduce this pressure
- May also wish to have balance sheet capacity in the event of another recession
  - The likelihood of hitting the ZLB has increased
  - Due to low inflation, and low equilibrium real rate
- No plan at present to return to an era of reserves scarcity (i.e. peg the funds rate by small open market operations)
  - With so much money in the banking system, how to raise rates?
The corridor system

Borrowing:
Fed sets primary credit rate at 1.5%
- No one will borrow above PC rate
- Normally, won’t lend below IOR
- To be extra sure, use reverse repo rate—another lending rate—to firm up floor on interest rates

Expected range of interest rates

Effective range

Expected range of interest rates

Sources: Author’s calculations
How’s that corridor system working?

Federal Funds [Effective] Rate (% p.a.)
Rate on Required Reserves - IORR (%)
FRB Temp OMOs: Fixed-Rate 1-Day Rev Repo: Award Rate on Treas...
A few other issues

- Monetary policy in a low-inflation, low-equilibrium rate environment
  - Optimal inflation rate
  - Overshooting, price-level targeting, etc.

- Open positions on the Board of Governors
  - Plus Chair and Vice-Chair terms expiring in 2018

- Legislation to change the Fed’s operating regime?

- Changes to regulatory landscape?