The outlook and current topics in monetary policy

Emerging Leaders in New England's Banking Industry

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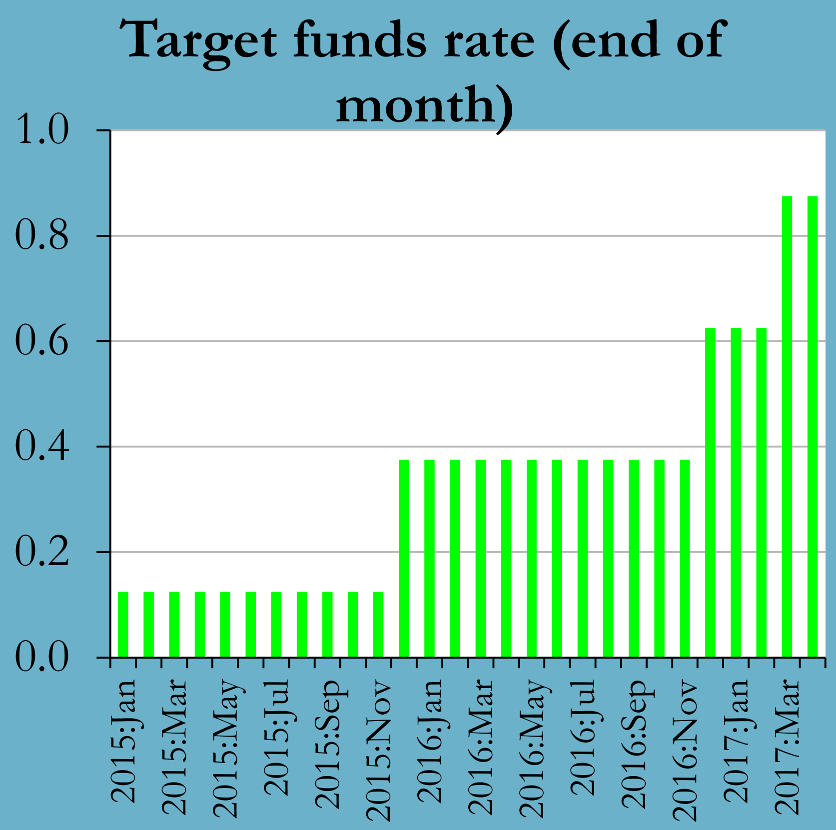
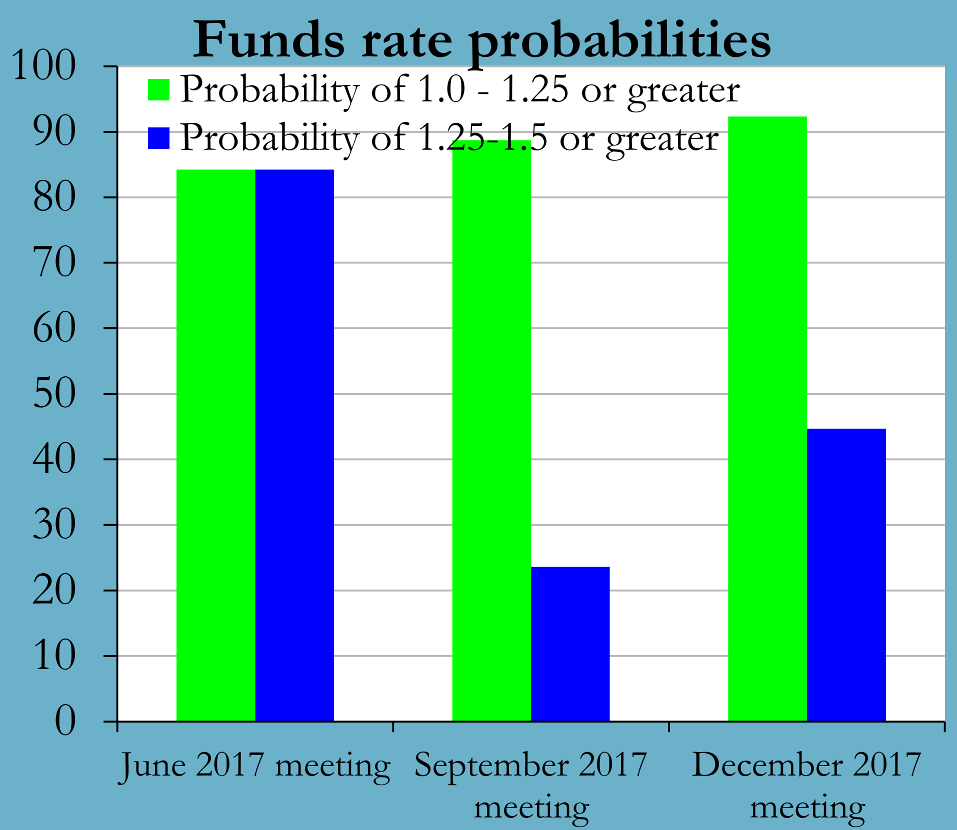
What's the Fed up to?

- Raising rates?
- Raising rates more this year? Next?
- If so, why?
- Are there risks to keeping rates too low?

The quick answer

- Is the Fed raising rates? So far, yes
  - Three increases so far. Diversity of opinion about the future…

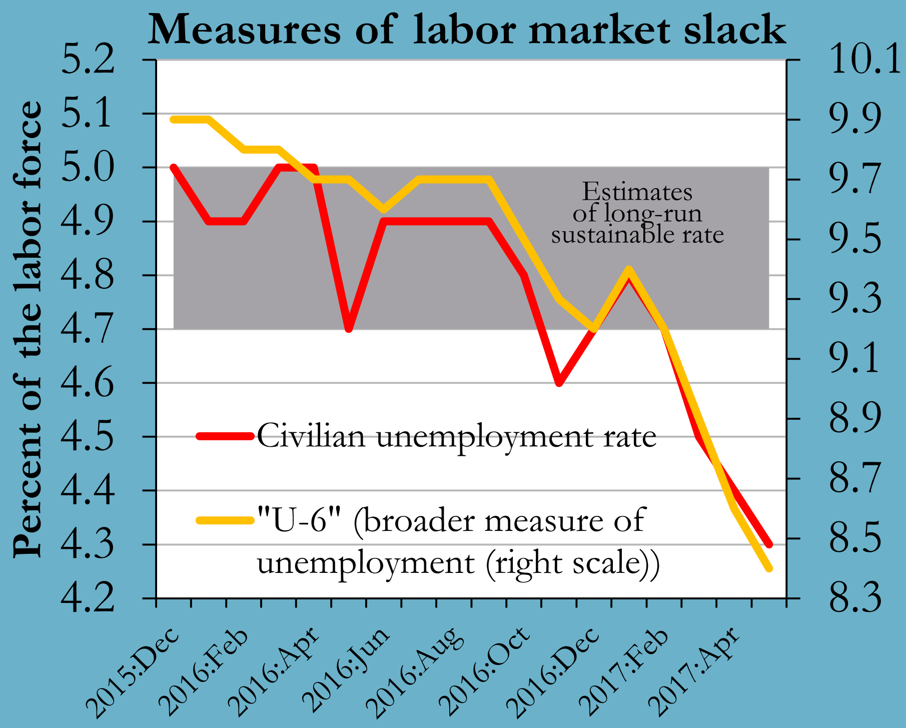


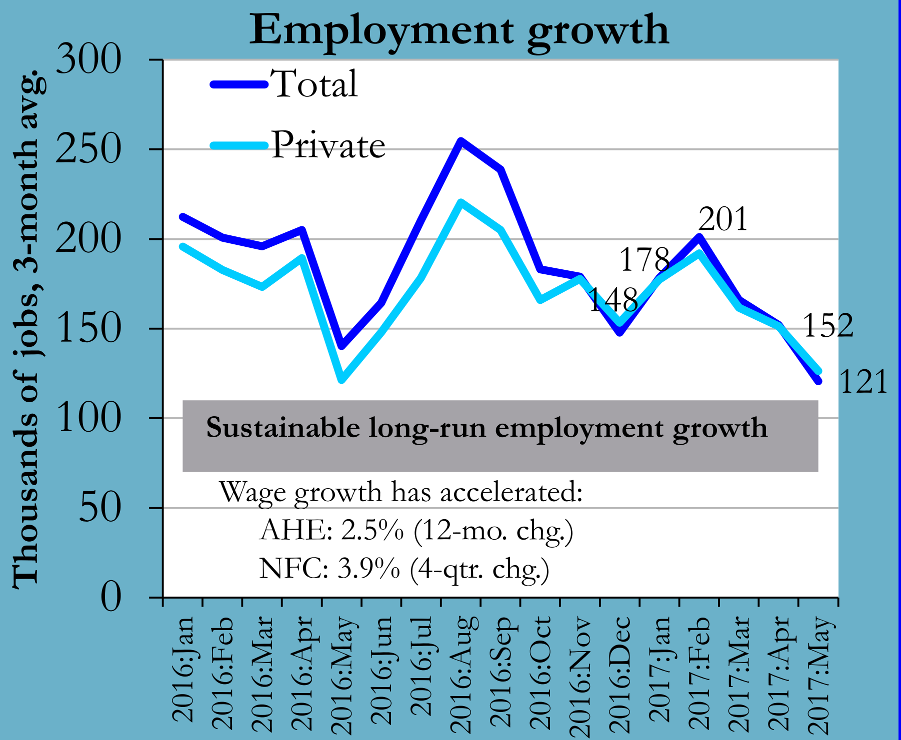


Source: FRB H.15 release (funds rate), Board of Governors of the Federal Reserve System, CME FedWatch tool (funds rate probabilities)

Why are they raising rates?

- Our responsibilities
  - The "Dual Mandate": low inflation, maximum (sustainable) employment
  - Where are we in achieving these goals? First, employment:

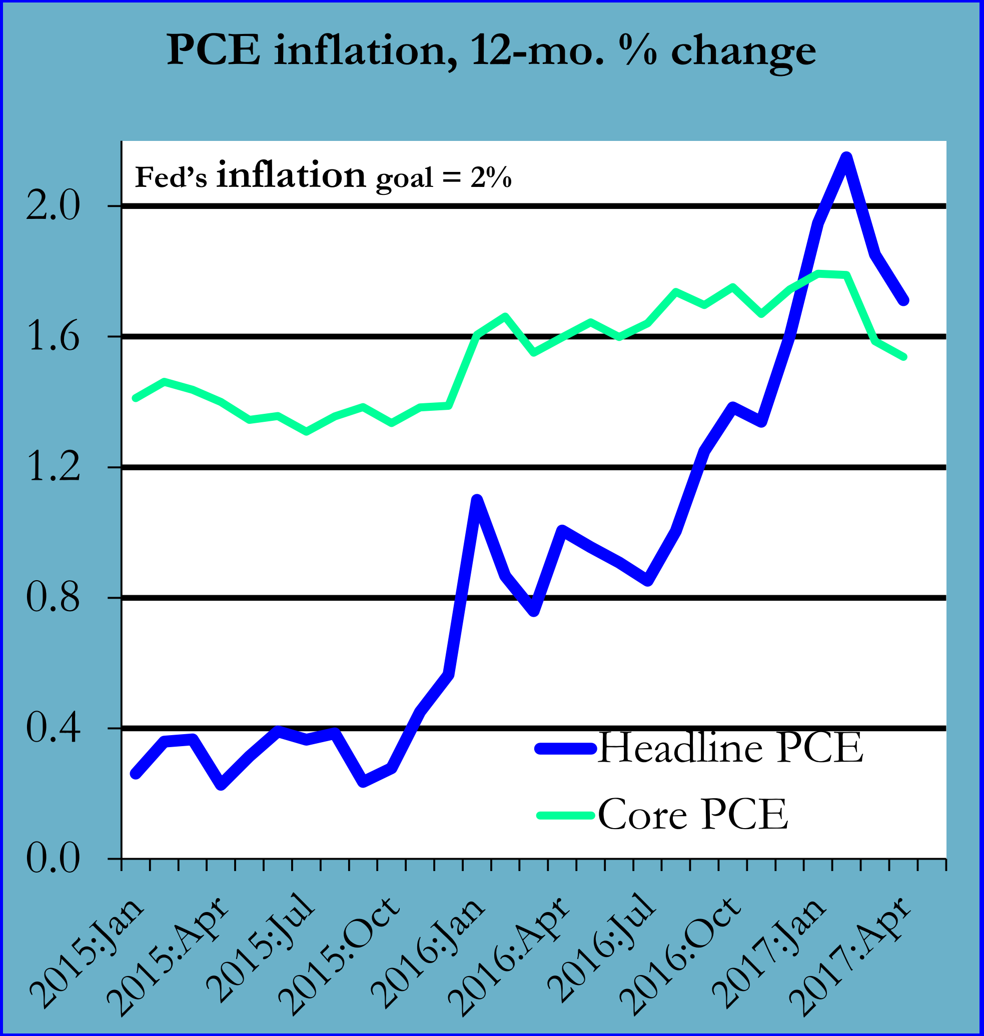




Sources: Bureau of Labor Statistics (unemployment, employment, AHE wage growth, nonfarm compensation), Haver Analytics

Why are they raising rates?

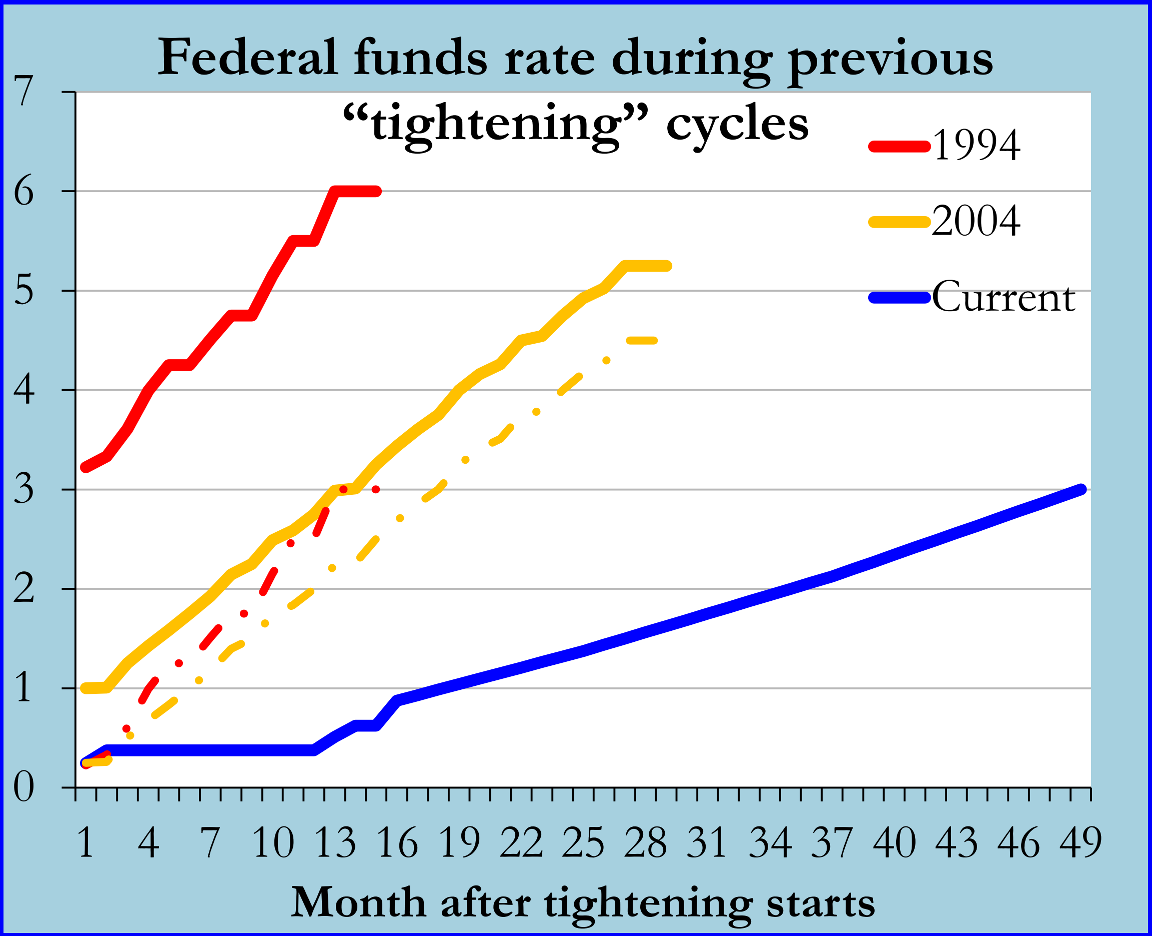
- <u>Inflation</u>: What's our goal? **2%**
- How close are we?
  - Pretty close
- Some of these movements are likely temporary
  - Increases, decreases in energy, import prices—and cell phone prices!
- We are OK with modest deviations <u>on either side of 2%</u>



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



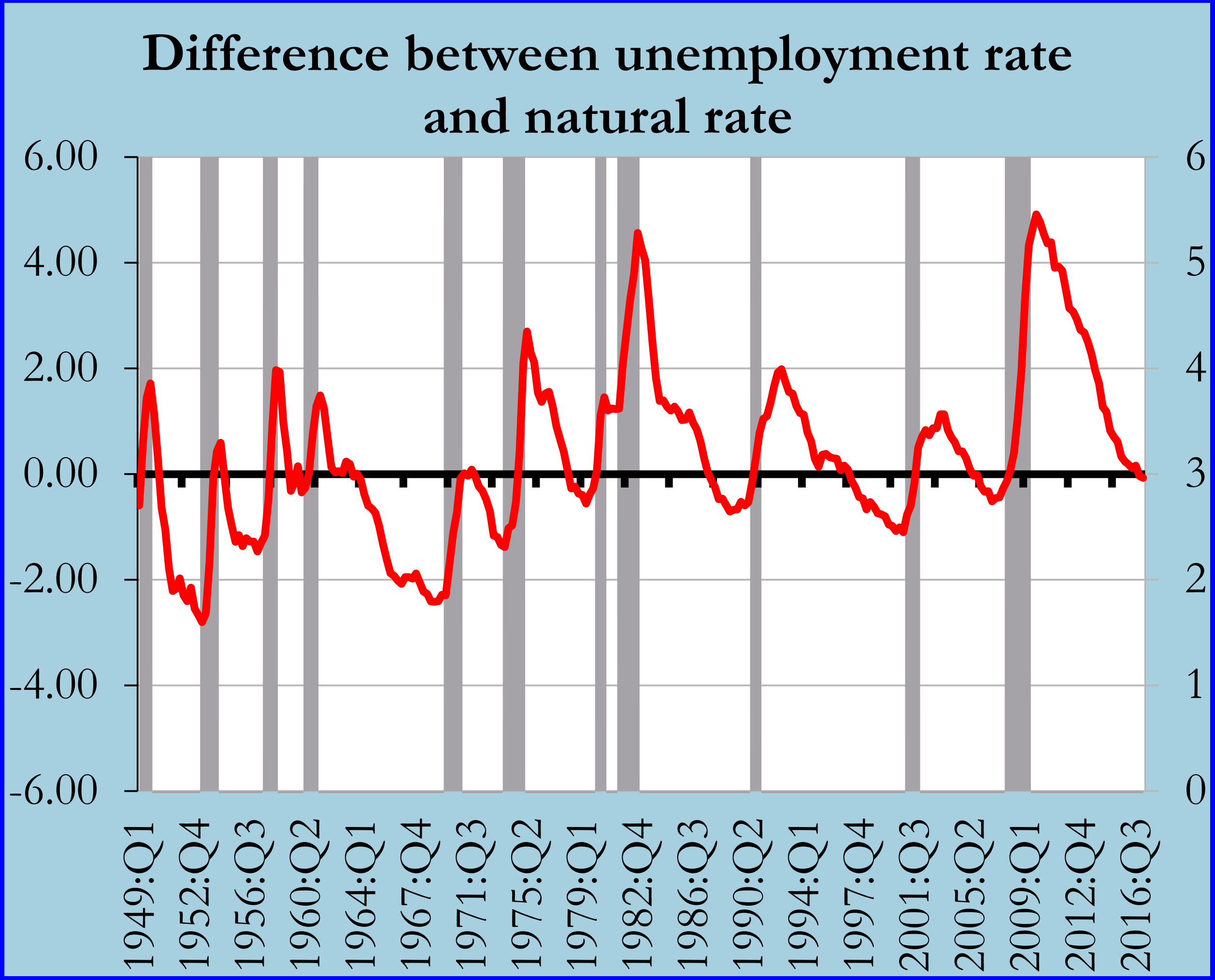
Sources: FRB H.15 release, Haver Analytics

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

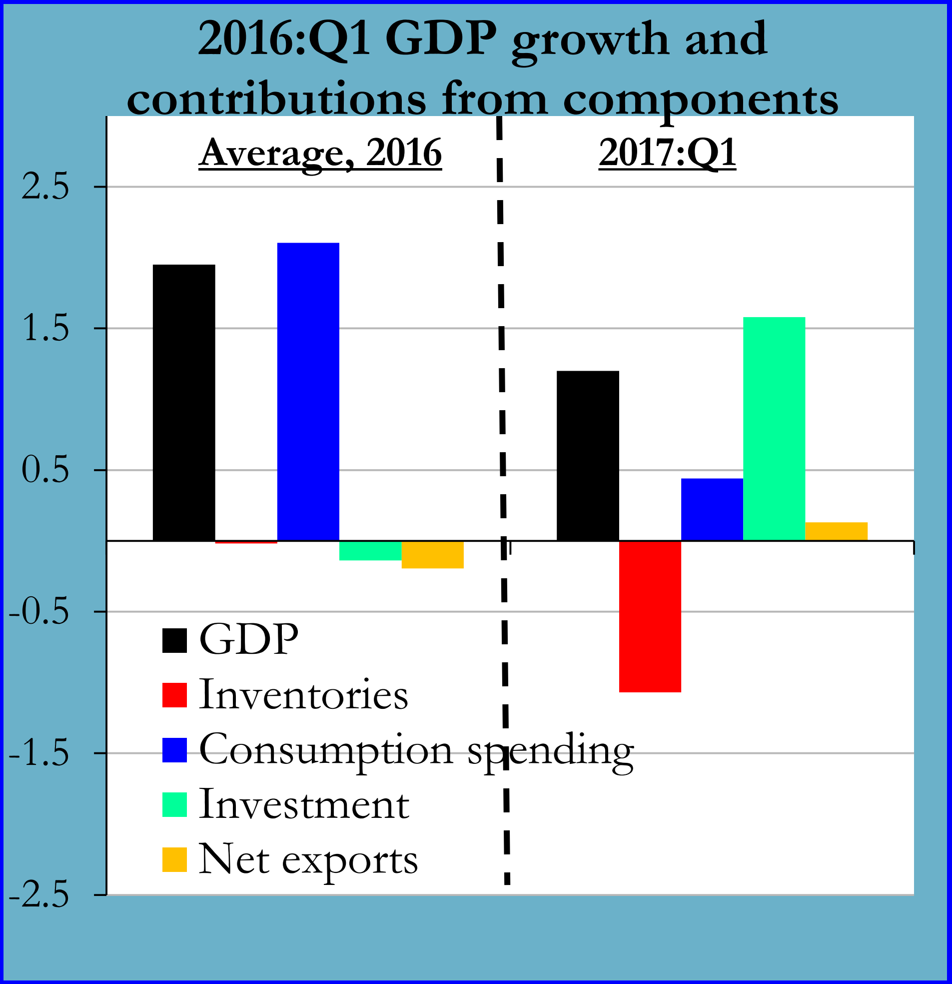
- This chart almost speaks for itself
- In <u>every</u> episode post World War II, unemployment slipping too far below normal leads to a recession
- We'd prefer a stable, sustained recovery



Sources: Bureau of Labor Statistics (unemployment rate), Congressional Budget Office (natural rate of unemployment), Haver Analytics

Recent history and the outlook

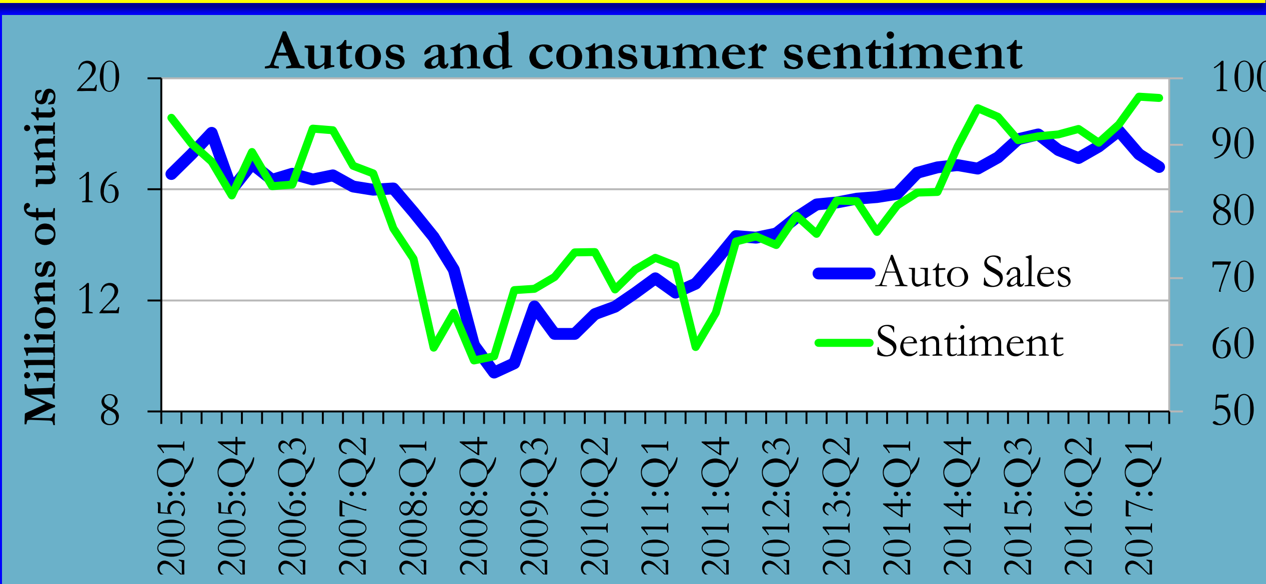
- Weaker growth than expected in the first quarter
  - Inventories subtracted almost one percentage point
  - Consumer spending grew by less than 0.5%
    - Warm weather, delayed tax refunds, poor seasonal adjustment
  - But underlying supports—income, wealth, sentiment—are good
- So I expect a rebound for the rest of the year, to an average of a bit greater than 2%

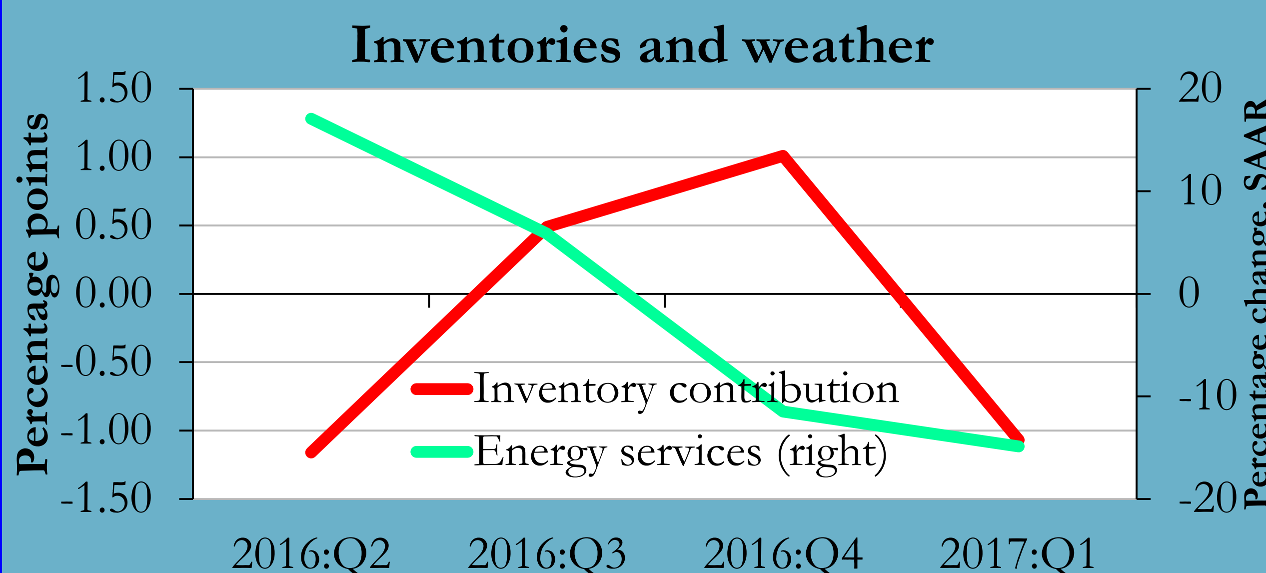


Sources: Bureau of Economic Analysis (GDP and its components), Haver Analytics

A closer look at transitory factors

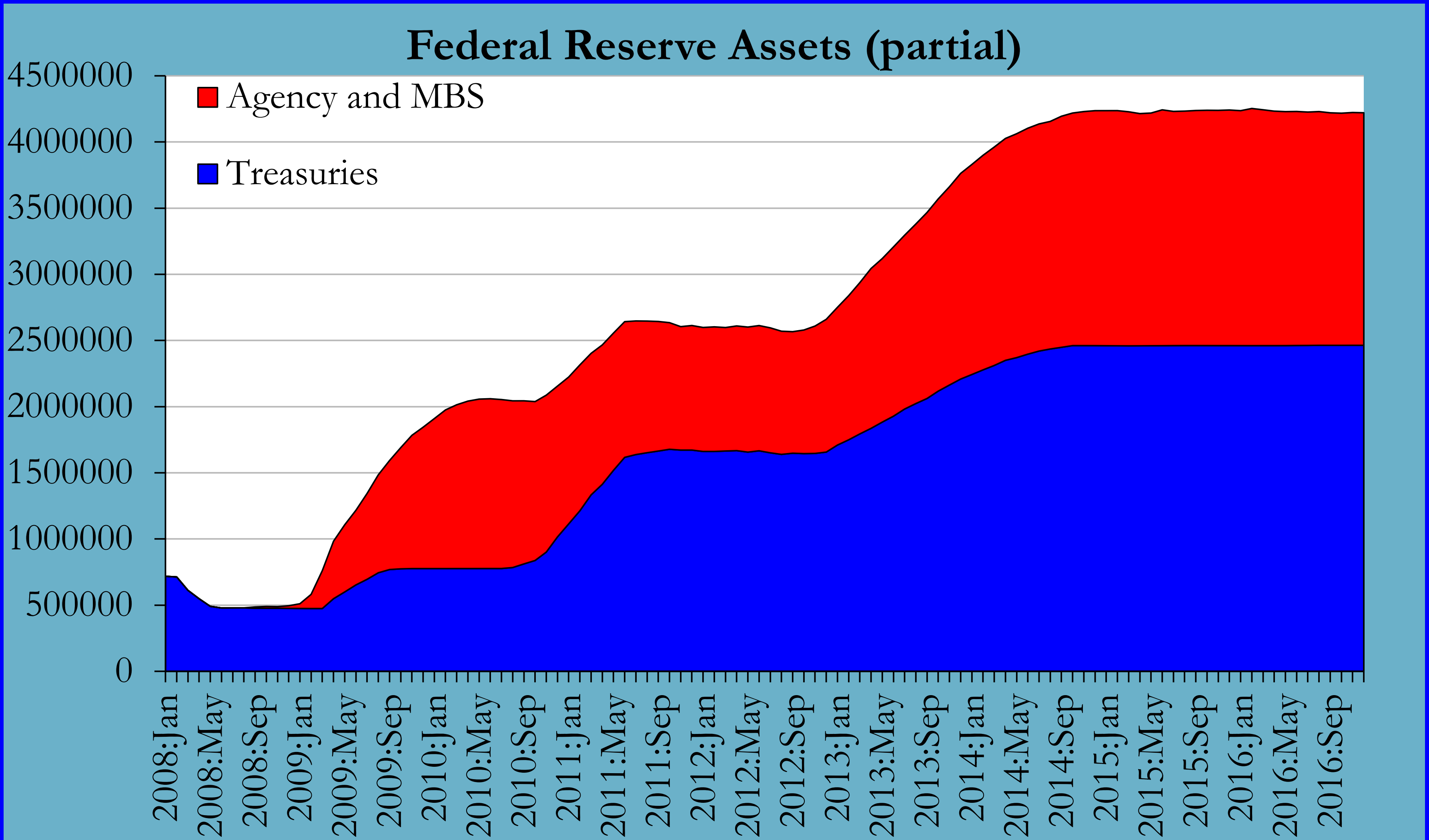
- Autos
  - Still at a very high rate
  - Energy services
    - Mild weather in Q1
- Inventories





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.

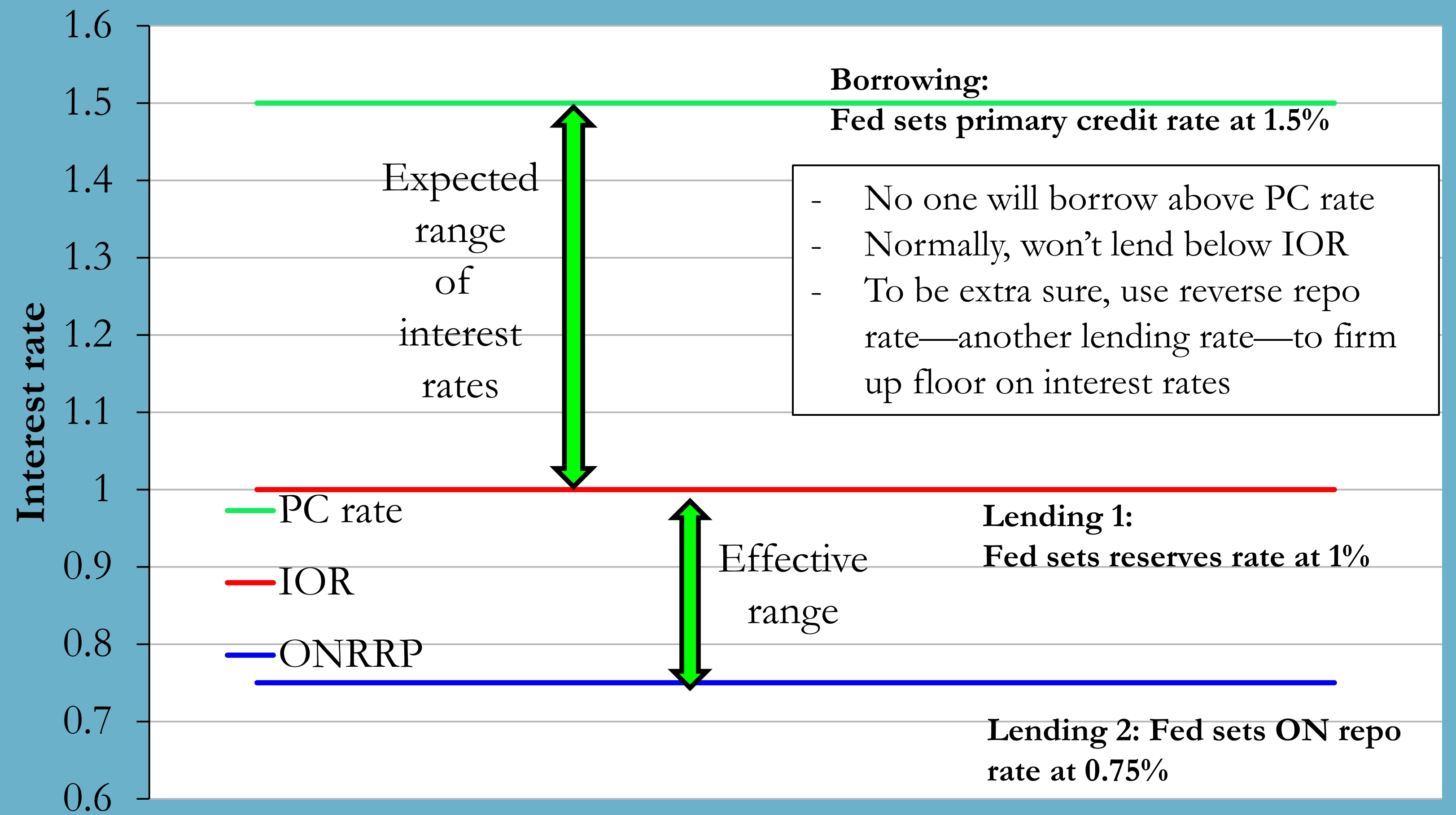


Sources: Federal Reserve H.4.1 release, Haver Analytics

Why reduce the balance sheet size? When?

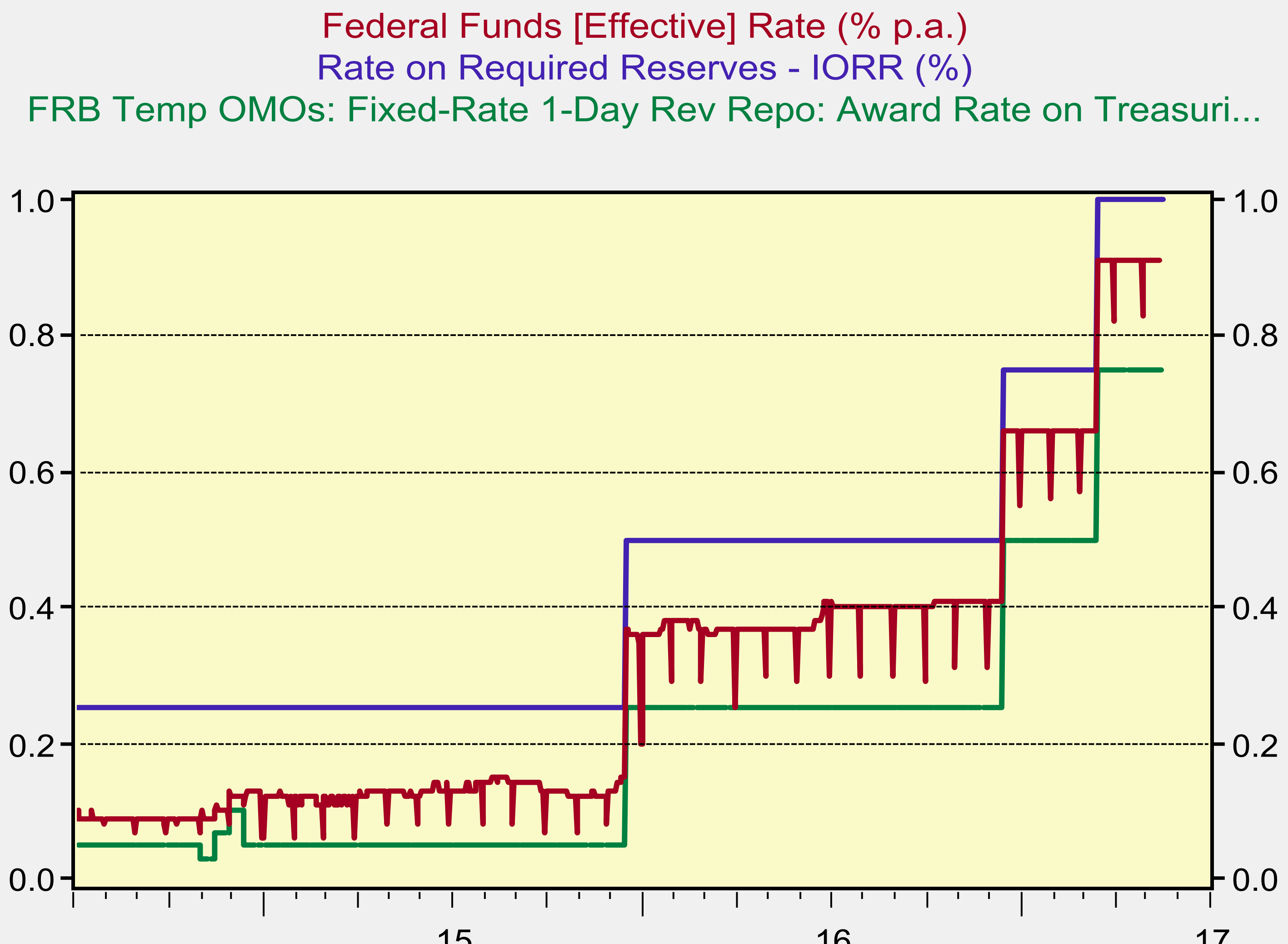
- Our holdings of securities are still exerting downward pressure on long-term rates
  - As part of normalization, reduce this pressure
- May also wish to have balance sheet capacity in the event of another recession
  - The likelihood of hitting the ZLB has increased
  - Due to low inflation, and low 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



Sources: Author's calculations

How's that corridor system working?



Sources: FRB, FRBNY /Haver

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?