U.S. Monetary Policy and National Economic Outlook

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Overview

1. Current National Economic Situation
2. FRBSF National Economic Forecast
3. U.S. Monetary Policy

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CURRENT NATIONAL ECONOMIC SITUATION
• Near-term momentum is weakening, improvement in growth is expected going forward.

• Despite improvement in the labor market, the unemployment rate remains elevated.

• Inflation has been subdued and is expected to remain below the Fed’s 2% target over the next few years.
A Large Gap Remains Between Potential GDP (inflation adjusted) and Actual GDP

**Actual Real GDP versus Potential Real GDP**
Trillions of chained 2005$; SAAR

Output Gap = -5.8% Percent of Real GDP

Source: Bureau of Economic Analysis, Congressional Budget Office

10/24/2013
Total Payroll Jobs Are Still Below the 2007 Business Cycle Peak
Low Interest Rates Contribute to the Rebound in Housing Construction

New Single Family Housing Starts
In thousands of units; SAAR

Housing Starts (three-month average)

Trend

Source: Census Bureau

10/24/2013
Low Interests Rates Support Vehicle Sales
Household Spending Is Holding Up

Real Personal Consumption Expenditures
Percent change at an annual rate; quarterly aggregation; SAAR

Source: Bureau of Economic Analysis
10/24/2013
Improved Households’ Net Worth Supports Consumption Spending (via Wealth Effects)

**Household Wealth**
As a multiple of disposable income

- **Net worth (Left Scale)**
- **Real estate (Right Scale)**

Source: Flow of Funds

Graph showing trend of household wealth over time with notable peaks and troughs.
Manufacturing Sector Is Recording Stronger Growth

ISM Composite Indices
Above 50 sector is expanding; below 50 sector is contracting

Index values

Source: Institute for Supply Management 10/24/2013
Fiscal Policy Restrains Growth

Federal Expenditures and Receipts
Twelve-month moving average

Source: CBO
10/24/2013

Next release is scheduled on or before November 18, 2013
Expect Growth at Moderate Pace

Source: FedViews, October 10, 2013
Expect Continued Gradual Improvement in the Labor Market

6.5% Unemployment Rate Threshold for the Fed Funds Rate “Liftoff”

Source: FedViews, October 10, 2013
Expect Inflation to Remain Stable

**PCE Price Inflation**
Percent change from 4 quarters earlier

FOMC’s 2% Inflation Goal for Overall PCE Price Index

PCE = Personal Consumption Expenditures. Core PCE excludes food and energy.

Source: FedViews, September, 20, 2013
Potential Risks to the Forecast

Uncertainty abounds:

• Effects of:
  • Government shutdown
  • Debt ceiling
• Waning of the fiscal drag
• Economic impact of the increase in long-term interest rates since the summer
U.S. MONETARY POLICY
Congress has set these two monetary policy goals for the Federal Reserve:

1) Promote maximum sustainable output and employment

2) Promote stable prices

Statement of FOMC’s longer-run goals and policy strategy (Jan 2012)

- Inflation target of 2 percent
- Estimates of the longer-run normal rate of unemployment with a central tendency of 5.2 to 6 percent

Policy Actions

• Conventional Monetary Policy
  – Target short-term interest rates (open market operations)
  – Provide liquidity to banking institutions (discount window)
Recent Downturn: Conventional Policy Was Not Enough

Actual versus "Implied" Fed Funds Target
In percent; quarterly aggregation

Fed Funds Target Rate

"Rule" Target Rate

monetary policy funds rate shortfall

Rule = 2.1 + (1.3 x Inflation) - (2.0 x Unemp. Gap)
Unconventional Monetary Policy Actions

- Influence long-term interest rates more directly
  - Large-scale asset purchases (LSAPs or QE)
  - Communications

- Provide liquidity more broadly to the financial system (new credit facilities during the crisis)
LSAPs Increase the Size and Change the Composition of the Federal Reserve Balance Sheet
Estimated Impact of LSAPs

• **Financial Markets**
  3 - 4 basis points (0.03 – 0.04 percentage points) decline in 10-year Treasury for each $100 billion purchased
  Williams 2013

• **Real Economy**
  LSAPs 1 & 2: 1.5 percentage points reduction in unemployment rate (=3 million jobs)
  Chung et. al 2012
Forward Guidance on LSAPs

• Qualitative guidance regarding QE3 Policy Decision

(Currently $85b/month in long-term asset purchases):

• Labor market conditions
  • “Substantial improvement”
• Cost/benefit analysis
Forward Guidance on Funds Rates Target

• Quantitative guidance regarding FOMC expectations for the federal funds rate target Policy Decision (Liftoff from the zero overnight federal funds rate):
  
  • Initially a Calendar Date
  • Numerical Thresholds for labor markets and future inflation
Forward Guidance for the Federal Funds Rate: Information About Expected “Liftoff date”

- 08/11: “mid-2013”
- 01/12: “late 2014”
- 09/12: “mid-2015”
- 12/12: calendar date-based guidance replaced with numerical thresholds
Exceptionally low range for the federal funds rate will be appropriate for at least as long as:

1. The unemployment rate remains above 6-1/2 percent
2. Inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and
3. Longer-term inflation expectations continue to be well anchored

NOTE: Thresholds are not triggers! Decisions are conditional on economic developments!
Quantitative Guidance for Individual FOMC Members Regarding Their Expectations for the “Liftoff” of the Federal Funds Rate

Appropriate Pace of Policy Firming

Target Federal Funds Rate at Year-End

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<th>Percent</th>
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<td>Longer run</td>
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<td>2012</td>
<td>1</td>
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Sequence for Policy Normalization

– Stop security purchases

– Stop reinvestment when securities pay off

– Push up short-term money market rates
  • Increase federal funds rate target
  • Increase interest rate on reserves
  • Increase discount rate
Summary

National Economy:

• Moderate growth in 2013, improving in 2014 will result in a gradual decline in the unemployment rate towards the FOMC’s 6.5 percent threshold.

• Inflation to rise towards the Federal Reserve’s target of 2% over the next few years.

Monetary Policy:

Against a macroeconomic backdrop that includes high unemployment and low inflation, the FOMC will maintain its highly accommodative policy.
QUESTIONS?
THANK YOU!

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Appendix I: Recent Growth in the M2 Money Supply Remains Close to the Long Run Average Growth Rate
Appendix 2: Inflation Expectations from the Financial Markets: Treasury Inflation Protected Securities (TIPS) Remain Low
Appendix 3: Movement Toward Transparency: Forward Guidance on Two Policy Decisions

First Decision:

- Qualitative guidance regarding QE3 Policy Decision
  (Currently $85b/month in long-term asset purchases):
  - Labor market conditions
  - “Substantial improvement”
  - Cost/benefit analysis

Then:

- Quantitative guidance regarding FOMC expectations for the federal funds rate target Policy Decision
  (Liftoff from the zero overnight federal funds rate):
  - Initially a Calendar Date
  - Numerical Thresholds for labor markets and future inflation