Monetary Policy: The Context

Symposium: Reversing Federal Reserve Monetary Ease: When and How
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The views I express here are my own and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.
Objectives of Monetary Policy: Dual Mandate

- **Maximum Employment**
  - Full utilization of labor resources
  - Rule of thumb: unemployment rate = “natural rate”
  - Natural rate varies through time
    - Currently ≈ 5.0% – 5.2%

- **Price Stability**
  - PCE inflation = FOMC goal $\pi^*$
    - $\pi^* = 2\%$
Employment Mandate

Private Nonfarm Payroll Employment
(change, thousands)

Monthly change

3-month average

Feb-2015

Unemployment Rate
(percent)

Feb-2015
Employment Mandate

**Labor Force Participation**
(Percent)

**Wage Growth Disappointing**
(4-quarter percent change)

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*FRBCHI staff estimates*
Real and Potential GDP

Real GDP
(bil. 2009 $)

Actual
Potential

Q4-2014
Price Stability Mandate

PCE Price Index
(12-month percent change)

Total
Core
FOMC Long-run Target
FOMC Projections*

*Midpoint of the central tendency of the forecasts made by FOMC participants as of March 18, 2015
Inflation Expectations

**Inflation Surveys**
(percent)

- University of Michigan for CPI: 5-year ahead
- Survey of Professional Forecasters for PCE: 10 years ahead

**TIPS Inflation Compensation for CPI**
5-10 years ahead
(percent)

- 18-Mar-2015
World Rates

10-year Government Bond Yield
(percent)

Consumer Inflation Growth Rates
(percent, year-over-year change)

Latest Japan CPI data adjusted for consumption tax increase.
Yields

Primary Dealer Survey Rate Projections: 10-year Treasury Yield
(percent)

Government Bond Yields (percent)

Projections as of January 2014

As of 18-Mar-15

U.S.
U.K.
Japan
Germany
Stability Considerations: A Third Mandate?

Do low interest rates induce excessive “reach for yield?”
   – Perhaps, for investors with quasi-fixed nominal liabilities

- **High yield spreads over Treasuries**
  - Last week: 4.79%
  - Average 1997 – present: 5.81%
  - June 2007: 2.50%

- **Covenant-lite loan volume**
  - 2014: $238.5 bil (67% HY)
  - 2007: $ 96.6 bil (65% HY)

- **Split B or lower new issue volume**
  - YTD: 11% of HY total
  - 2014: 18% of HY total
  - 2007: 36% of HY total

- **Buyout multiples**
  - 2014: 9.4 x EBITDA
  - 2007: 9.3 x EBITDA
To Raise Rates – Or Not?

Arguments for raising rates within the next few months

- We’re well on our way to full employment
- Inflation has been pervasively low, but will rise towards our target as we move to full employment
- Weakness in the rest of the world will not have a huge impact on U.S. growth or inflation
- Pervasive reach for yield could destabilize financial markets

Arguments for delay

- Not a hint of inflation
- Appreciating dollar imports disinflation from abroad
- Asymmetry at the ZLB,
  - damage from above-target inflation much less than damage from another contraction (1937 ?)
- Financial stability should be addressed by regulation.
Market Expectations as of 3/18/2015

Source: Interest rate projections are from the March 18, 2015 FOMC Summary of Economic Projections. Market expectations are from OIS futures as of March 18, 2015.
Looking Ahead: Policy Normalization

- At some point, progress on policy mandates will dictate higher interest rates

- Need to make sure we can raise short-term market interest rates in the presence of a large balance sheet

- In the past, we would influence the federal funds rate by changing the supply of bank reserves.
  - Will this work in the current environment where reserves are plentiful?

- New tools to affect short-term market rates
  - IOER, ON RRP, Term RRP
  - Increases in these rates raise other rates through arbitrage in money markets
Monetary Policy

Federal Reserve Liabilities
(Bil. $)

Total Liabilities
($4,533 bil.)


- Currency ($1,355 bil.)
- Bank Reserves ($2,688 bil.)
- Deposits ($121 bil.)
- Repurchase Agreements ($264 bil.)
- Other Liabilities ($66 bil.)
- Treasury Accounts ($39 bil.)
Policy Normalization Tools

- IOER: Interest on Excess Reserves held at Fed
  - Only depositories (DIs) can earn IOER

- ON RRP: Overnight Reverse Repurchase Agreement: place dollars at Fed in a repo at interest rate set by FOMC
  - Available to a range of participants in short-term money markets: DIs, GSEs, Broker-Dealers, MMFs
  - Cap on total amount invested in ON RRP

- Corridor approach:
  - FOMC announces a range for the fed funds rate
  - Sets IOER rate at the top of the range (“ceiling”)
  - Sets ON RRP rate at the bottom of the range (“floor”)

- Evidence: ON RRP rate provides a firm floor provided cap is not binding.