Making Monetary Policy at the Fed

Kalamazoo College
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The views expressed are my own and not those of the Federal Reserve Bank of Chicago or the Federal Reserve System
Federal Reserve Districts
Nice Marble

Board of Governors

Chicago Fed
The Federal Reserve Board of Governors*

Janet L. Yellen  
Stanley Fischer

Daniel K. Tarullo  
Lael Brainard  
Jerome H. Powell

*Two seats currently vacant
Presidents of the District Reserve Banks

Eric S. Rosengren*
First District - Boston

William C. Dudley*
Second District - New York

Patrick T. Harker
Third District - Philadelphia

Loretta J. Mester*
Fourth District - Cleveland

Jeffrey M. Lacker
Fifth District - Richmond

Dennis P. Lockhart
Sixth District - Atlanta

Charles L. Evans
Seventh District - Chicago

James B. Bullard*
Eighth District - St. Louis

Neel Kashkari
Ninth District - Minneapolis

Esther L. George*
Tenth District - Kansas City

Robert S. Kaplan
Eleventh District - Dallas

John C. Williams
Twelfth District - San Francisco

* 2016 voting FOMC member
FOMC Meetings
Monetary Policy: The Fed’s Dual Mandate

- Federal Reserve Act: Section 2a. Monetary Policy Objectives

- … the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.
Long Run Goals and Policy Strategy Principles

- **Price stability**
  - Goal: 2% inflation in price index for total personal consumption expenditures (PCE)
  - Target is symmetric: an average over medium term, not a ceiling

- **Full employment**
  - Employment goal may change over time for non-monetary reasons
  - Most FOMC participants see 4.8-5.0% unemployment as consistent with mandate (current forecast of long-run “normal” unemployment)
  - Seek an economy operating at its level of potential output

- **Balanced approach**
  - Balanced approach to achieving both goals if they are in conflict
  - Takes account of lags and other limits in effects of monetary policy
Monetary Policy In Usual Times

- Target the federal funds rate

- Changes in fed funds rate move other short-term interest rates

- Changes in short-term interest rates influence
  - Longer-term interest rates
  - Exchange rates
  - Asset values

- These then affect saving and investment decisions, which in turn influence employment and output

- Inflation influenced by these and factors
Policy Rate Constrained By Zero Lower Bound

**Federal Funds Rate**
(percent)

- Central tendency of FOMC long run projections
- Median of FOMC projections

1999 | '01 | '03 | '05 | '07 | '09 | '11 | '13 | '15 | '17
### Nontraditional policies for the ZLB:

1. Forward guidance about the fed funds rate
2. Large scale asset purchases

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**Central tendency of FOMC long run projections**

**Policy Rate Constrained By Zero Lower Bound**

**Federal Funds Rate**

(Percent)
Unemployment Rate

Unemployment Rate (percent)

- Actual
- NAIRU or “natural rate”*
- FOMC Projections

Central tendency of FOMC long run

Jan-2016

*FRBCHI staff estimate
FOMC projections are the median of projections from December 2015.
Source: Haver Analytics and Economic Projections of the Federal Reserve Board Members and Bank Presidents.
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What Happens Before the FOMC Meeting?

- **Board staff prepare and distribute to entire FOMC:**
  - Economic forecast (Tealbook Part A)
  - Monetary policy alternatives (Tealbook Part B)
  - Other analyses

- **Regional bank staffs prepare their bank presidents:**
  - Internal forecasts and analyses
  - Study Board staff documents
  - Help bank president prepare commentary on
    - Board staff materials
    - Personal economic outlook and policy views
What Happens at an FOMC Meeting?

- **Preliminaries**
  - Administrative matters
  - Often presentation on special topic

- **Report from the “Desk”**
  - NY Fed Markets Group: What’s up in financial markets

- **Tealbook Part A presentation**
  - The economic outlook

- **Financial stability report (quarterly)**

- **“First Go-Around”: Participants present views on regional and national outlook**
  - Supposed to avoid talking about policy; people cheat a little
What Happens at an FOMC Meeting?

- Tealbook Part B presentation: The policy options

- "Second Go-Around": Policy discussion
  - Participants give views of appropriate policy

- The Vote: The Chair gives sense of the consensus
  - Sometimes "word-smith" the FOMC statement
  - Only members vote

- Post-decision activities
  - Lunch
  - Sometimes presentation of a special topic
  - The Chair’s press conference (quarterly)
Communicating Policy Rationale to the Public

- **Immediately following the FOMC meeting**
  - Statement
  - Press conference and forecasts (quarterly)

- **Soon after meeting**
  - Minutes (3 weeks after meeting)
  - Speeches and testimony

- **Biannually -- Monetary policy report**

- **With a longer lag, meeting documents become public**
  - 5-years: Tealbook
  - 10-years: Transcripts
Appropriate Pace of Policy Firming

Federal Funds Rate at Year-End
(percent)

FOMC Communications: Data Dependence

- The actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

- Realized and expected conditions relative to maximum employment and 2 percent inflation.

- Take account a wide range of information:
  - Labor market conditions, inflation pressures and inflation expectations, and financial and international developments.
The Committee expects:

That economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate;

The federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.
Appendix
Appropriate Pace of Policy Firming

Federal Funds Rate at Year-End (percent)

Survey of Primary Dealers

Appropriate Pace of Policy Firming

Federal Funds Rate at Year-End (percent)

Appropriate Pace of Policy Firming

Federal Funds Rate at Year-End
(percent)

Short-Run Monetary Non-Neutrality

- Evidence from Christiano, Eichenbaum, and Evans (2005)
Model Estimates of $r^*$

A. Estimates of the neutral real rate in the longer run

![Graph showing estimates of the neutral real rate over time with quarterly data from 1985 to 2015. The graph includes two sets of estimates: one by Johannsen-Mertens and another by Laubach-Williams. Shaded regions indicate 50 and 90 percent uncertainty bands.]

**NOTE:** The data extend through 2015:Q3. For the Johannsen-Mertens model, at each date, the parameters of the model and the longer-run equilibrium real rate are jointly estimated using data up to that date. For the Laubach-Williams model, the parameters are estimated on the entire data sample, but estimates of the longer-run equilibrium real rate use data only up to the date of interest. Shaded regions are 50 and 90 percent uncertainty bands from the Johannsen-Mertens model. The shaded bars indicate periods of business recession as defined by the National Bureau of Economic Research.
How Did We Get In This Situation?

- Housing market boom and bust
  - Period of rapidly rising home prices, loose lending, and booming construction
  - Unwind was big drag on economy

- Financial market disruption
  - Surprising financial market fragility
  - Banks and “shadow banks” both highly stressed
  - Reduced credit availability slowed economy

- Business and consumer pessimism
  - Many disturbing events
  - Businesses and consumers become cautious; reduce spending

- As a result we got a very bad recession in 2008-2009 followed by a very slow recovery
Why Was the Recovery so Disappointing?

- **Long-lasting damage from the recession**
  - Difficult balance sheet restructuring by households, nonfinancial businesses and financial institutions
  - Scars from long-term unemployment, low capital formation

- **Additional shocks**
  - European crisis
  - Fiscal issues in U.S.

- **Continued business and consumer pessimism and uncertainty**
  - Precautionary behavior

- **Monetary policy runs into the zero lower bound (ZLB)**