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The Federal Reserve and Monetary Policy



The views expressed are those of the author and do not necessarily reflect the opinions of the Federal Reserve Bank of Kansas City or the Federal Reserve System.

Formation of the Federal Reserve

- By 1913, the U.S. faced several problems:
 - No national currency
 - No intermediary for processing checks
 - No lender of last resort
 - No coordination of money supply
- Who do you turn to when things go wrong?



The Federal Government



- The Challenge: Governments Inflate the Economy
 - Low interest rates reduce debt service costs
 - Low interest rates spur the job gains and inflation
 - With higher inflation, governments can avoid tax increases or spending cuts needed to manage debt levels

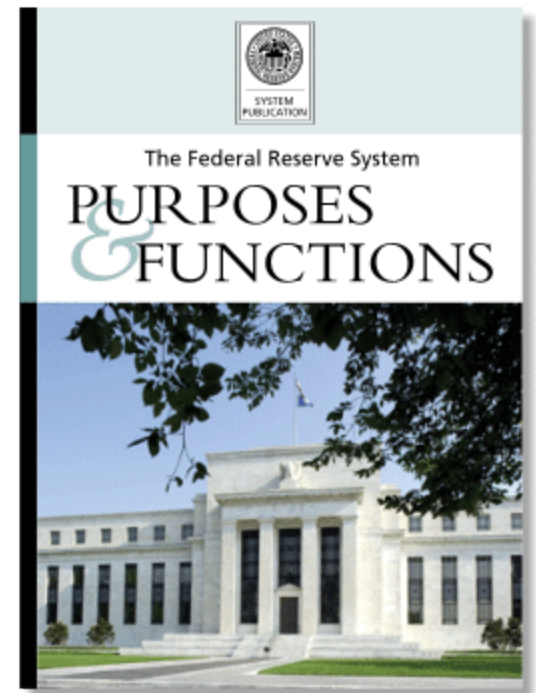


What is the Federal Reserve?

The Federal Reserve is the
Central Bank of the U.S.
(formed in 1913)

Functions

- *Conduct monetary policy*
- *Supervise and regulate banks*
- *Maintain stability of financial system*
- *Operate the nation's payment system*

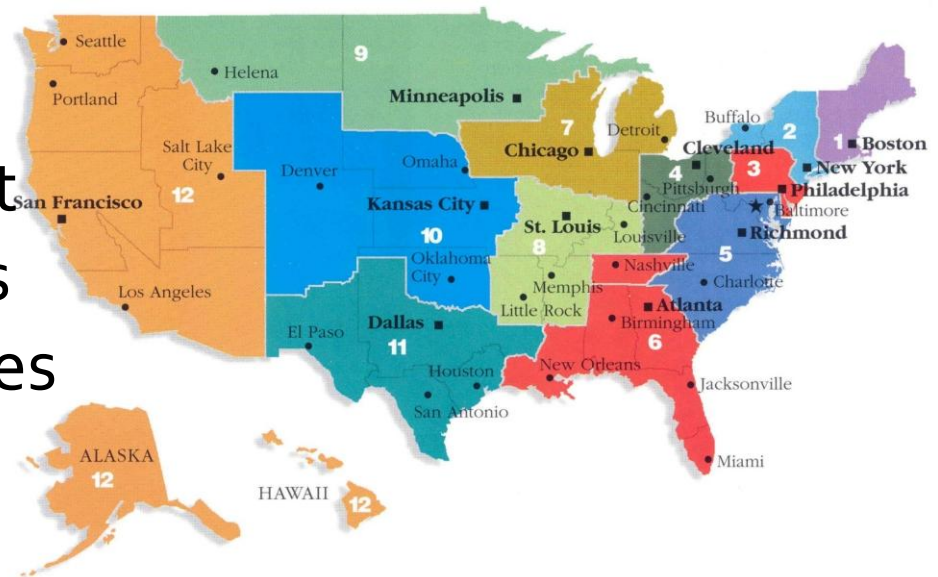


Federal Reserve: A System of Checks and Balances

- Board of Governors (BOG) in Washington DC (Political Appointees and Government Employees)
- 12 Regional Reserve Banks (Non-profit Corporations and Private Employees)

Public Control

- Congressional Oversight
- BOG Oversight of Banks
- Government Remittances



Two Kinds of Economic Policy

■ Monetary Policy

- Changes in the level of money and credit in the economy
- Implemented by the Federal Reserve

■ Fiscal Policy

- Changes in government spending and tax programs
- Implemented by the Executive and Legislative branches



Federal Open Market Committee

- Monetary policy making body
- 7 Governors,
- NY Fed President,
- 4 other Bank Presidents
- Remaining Bank Presidents participate in discussions



Discussion Question

What is the best way to structure the Federal Reserve and make it accountable to the public, but not controlled by politics?



The Fed's Toolbox: Monetary Policy Tools

- Primary Credit Rate
(Discount Rate)
- Open Market
Operations
(Fed Funds Rate)
- Reserve Requirements
- Balance Sheet



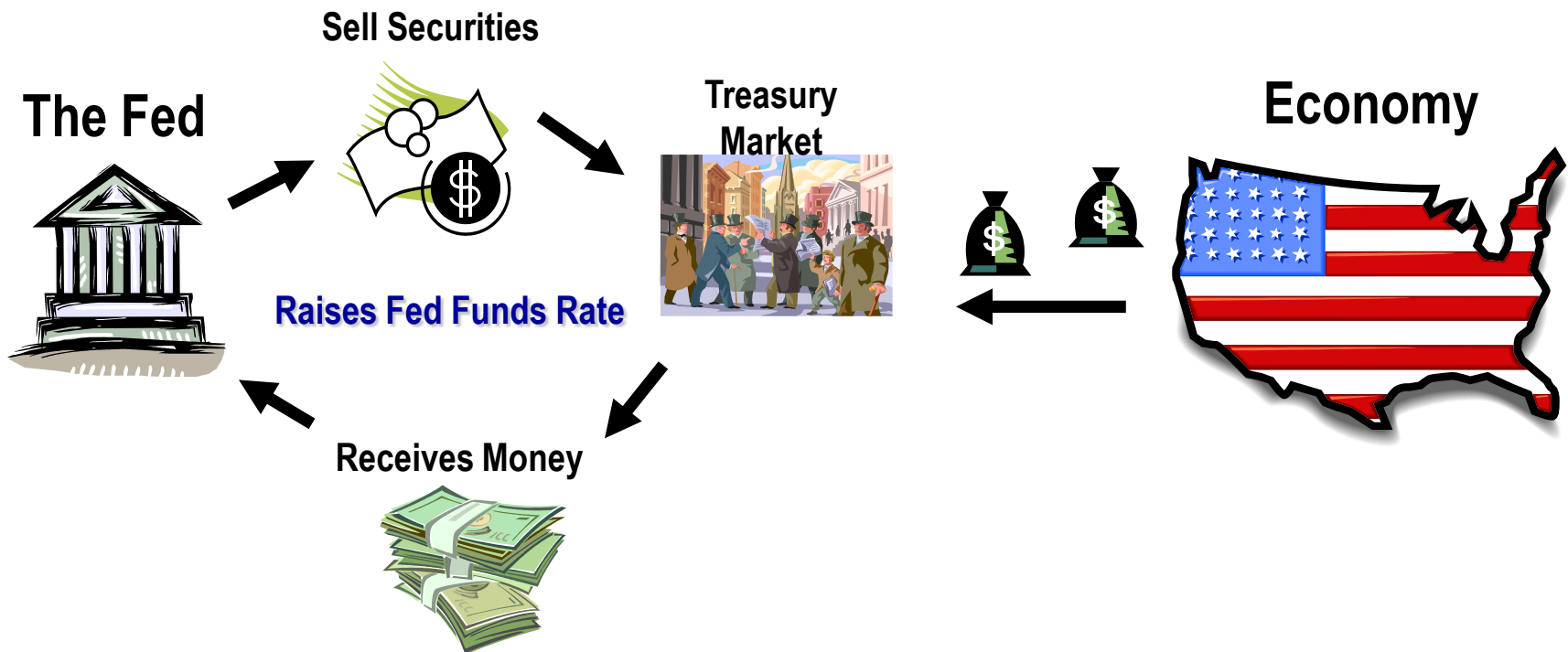
Primary Credit Rate (aka the Discount Rate)

- Rate of interest the Fed charges on loans to banks and other financial institutions
- Originally, the primary monetary policy tool.
- Today, a posturing signal for regional Reserve Banks
- A lower discount rate signals easier, expansionary, or accomodative policy
- A higher discount rate signals tighter, contractionary or less accomodative policy



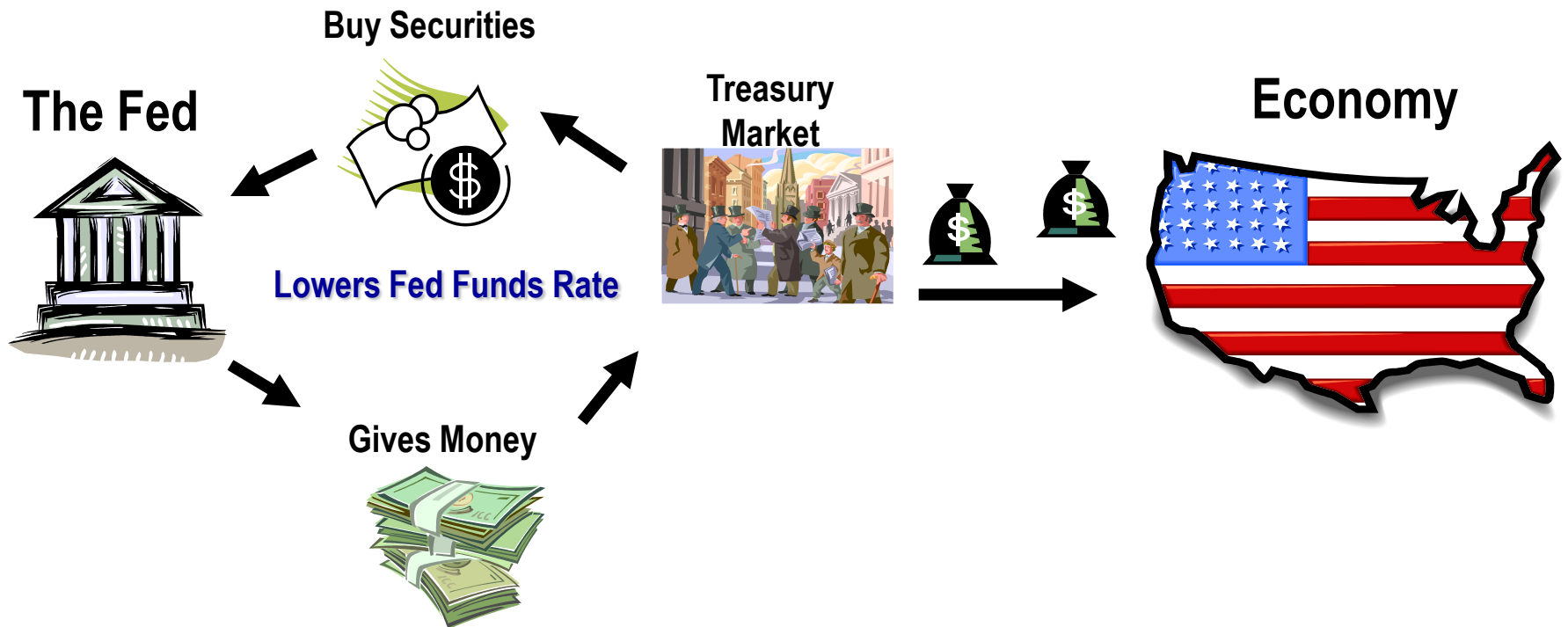
Open Market Operations & the Fed Funds Rate

Slow the Economy: Take Money Out of the Economy



Open Market Operations & the Fed Funds Rate

*Stimulate the Economy:
Place Money in the Economy*



The Balancing Act of Monetary Policy



Foundation based on the Phillips Curve



The Taylor Rule

Fed Funds Rate = Equilibrium Real Interest Rate + Inflation Rate + Deviation of Inflation from Target + Output Gap

$$i_t = rr^* + p_t + \beta(p_t - p^*) + \gamma(y_t - y_t^*)$$

What Can Economists Debate in the Taylor Rule?

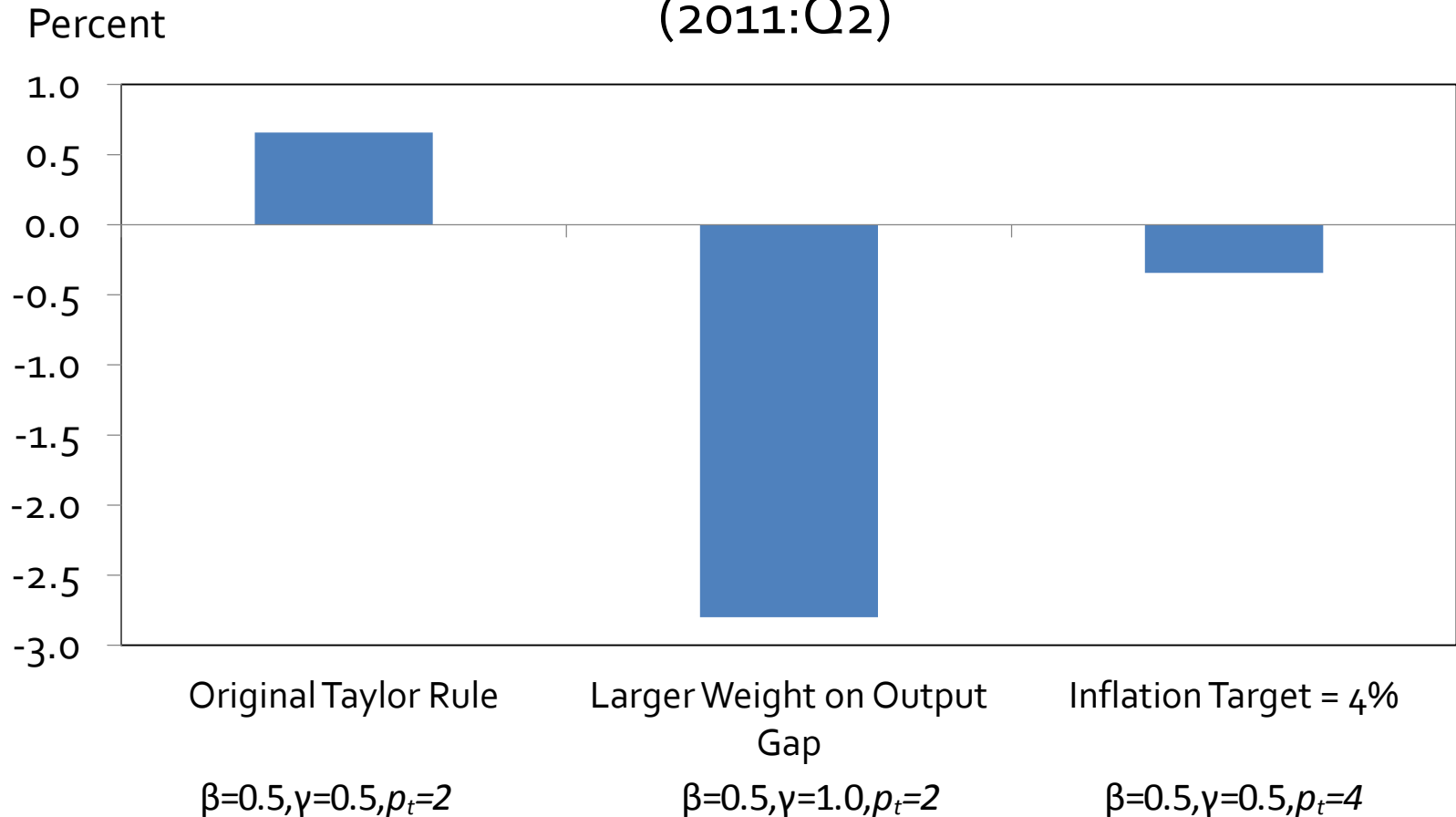
- Equilibrium real interest rate
- Inflation rate measure
- Inflation target
- Potential GDP
- Weights on inflation and output gap

George A. Kahn. 2010 "Taylor Rule Deviations and Financial Imbalances" *Economic Review*, Federal Reserve Bank of Kansas City, Second Quarter
<http://www.kansascityfed.org/Publicat/EconRev/PDF/10q2Kahn.pdf>



Assumptions Matter

Taylor Rule Outcomes (2011:Q2)



Viewpoints depend on your perspective.

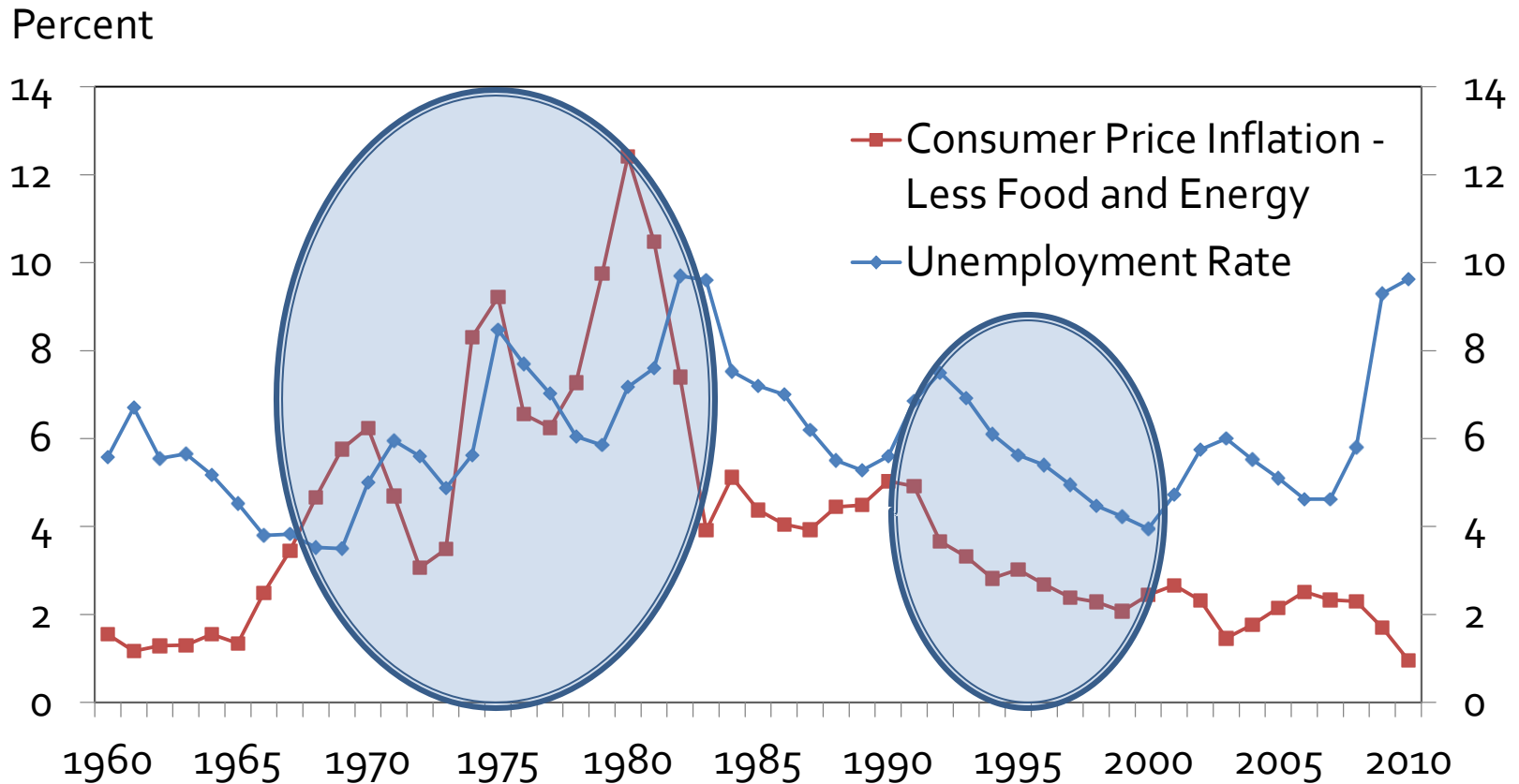


Discussion Question

What part of the dual mandate
(inflation or employment)
should drive monetary policy?



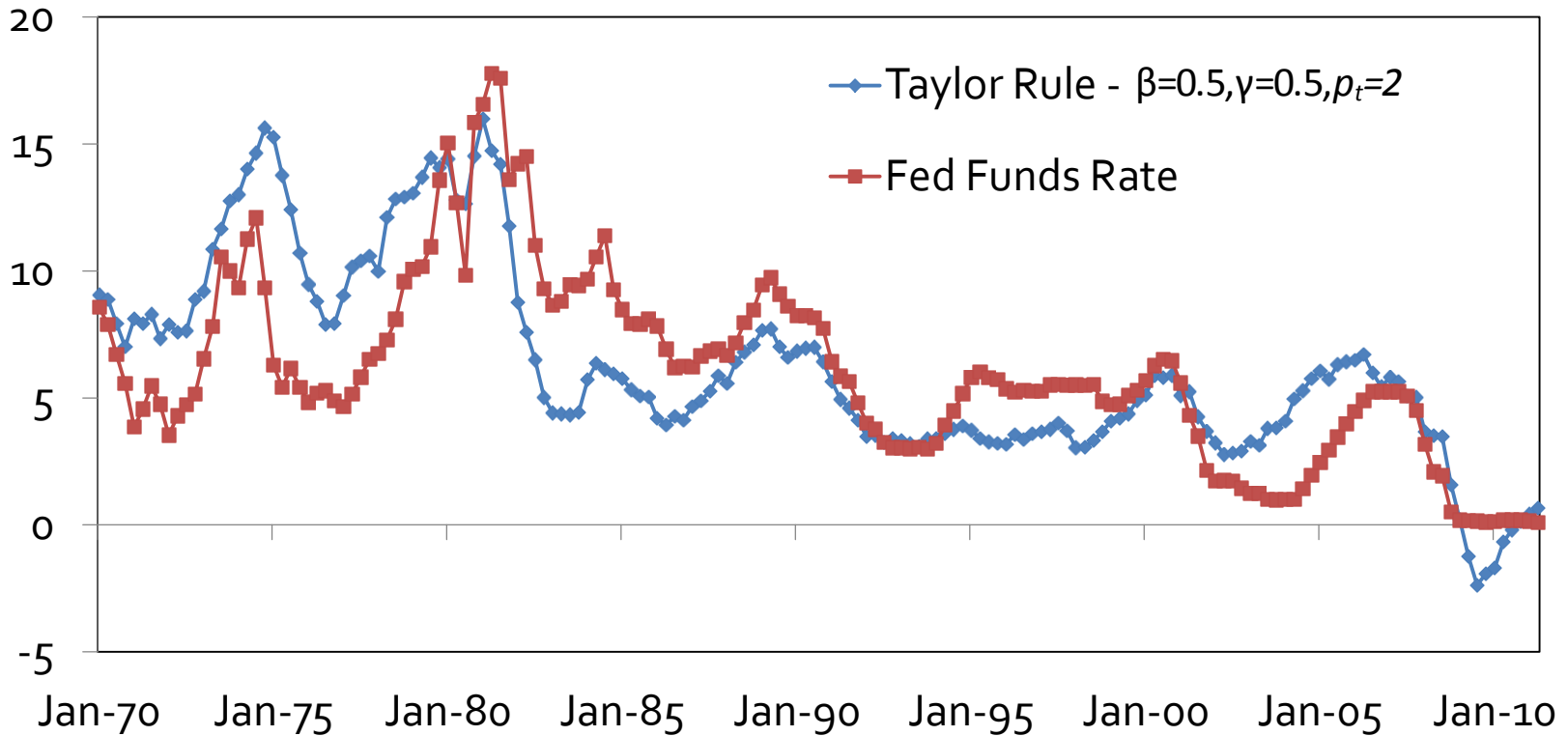
Is the Phillips Curve Dead or Alive?



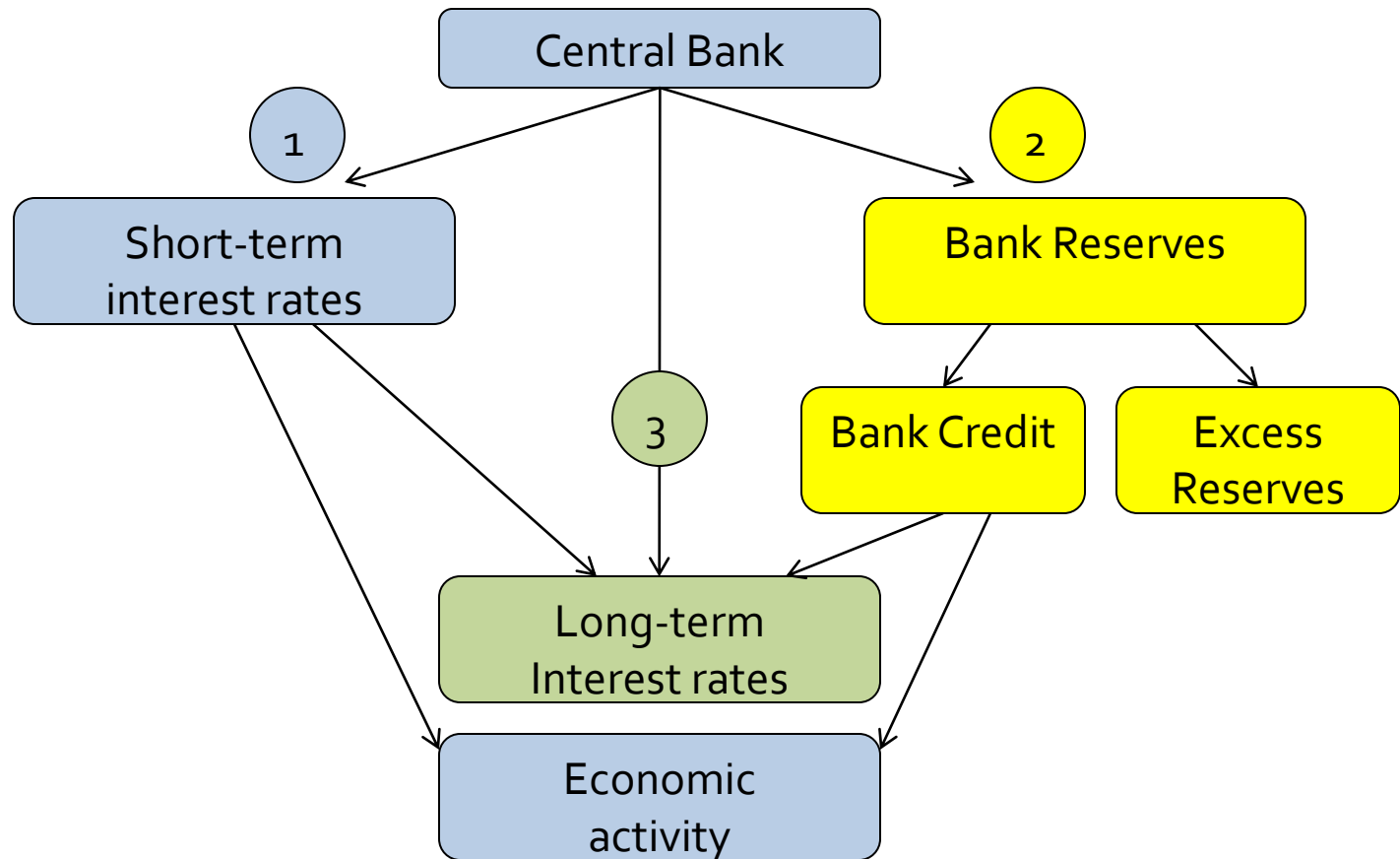
Has the Fed followed the Taylor Rule?

Effective Fed Funds Rate and Taylor Rule

Percent



Monetary Policy Transmission Mechanisms

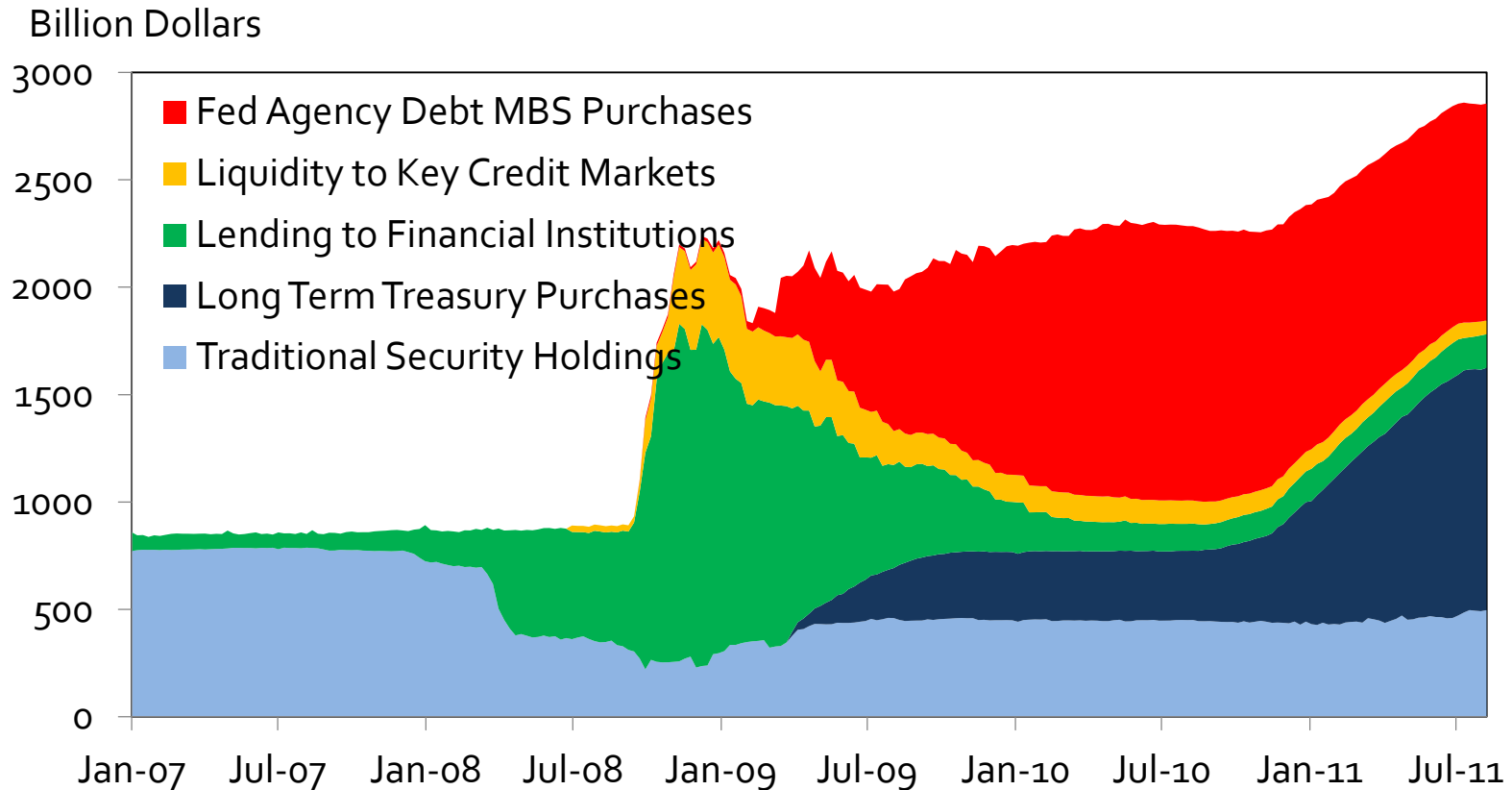


Source: Gordon Sellon (2003) "Monetary Policy and the Zero Bound: Policy Options When Short-Term Rates Reach Zero"
Economic Review <http://www.kansascityfed.org/Publicat/ECONREV/PDF/4q03sell.pdf>



A Larger Balance Sheet Boosts the Monetary Base

Federal Reserve Balance Sheet: Assets



Source: Federal Reserve Bank of Cleveland



Discussion Question

What are the costs and benefits
of Quantitative Easing?



Inflation is based on money and velocity.

Quantity Theory of Money

$$\text{Price} = \frac{\text{Money} * \text{Velocity}}{\text{Quantity}}$$

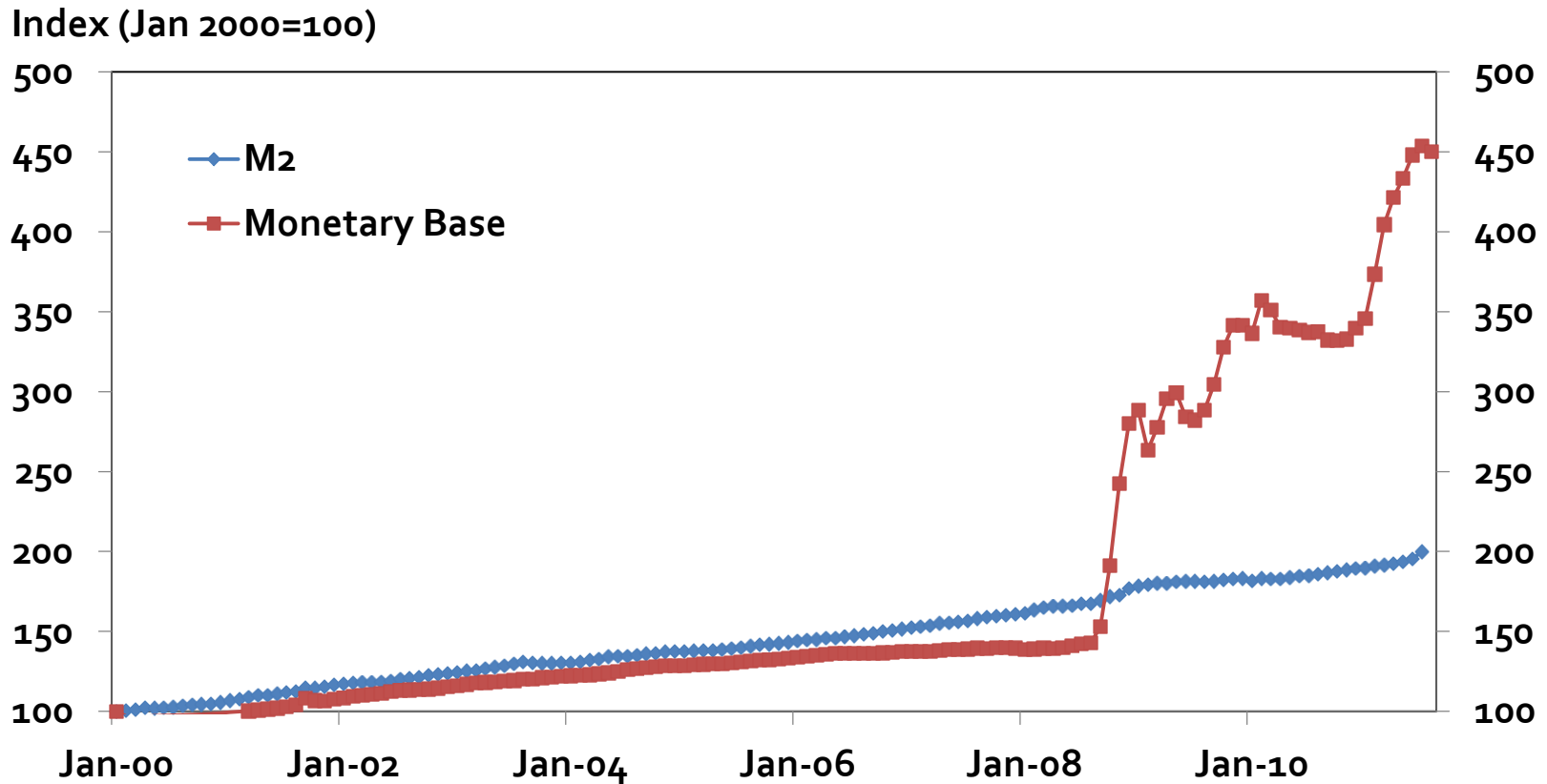
Definition of Inflation:

Too much money $M \uparrow$
chasing $V \uparrow$
too few goods $Q \downarrow$



The Monetary Base is not Money Supply

Growth in Monetary Aggregates



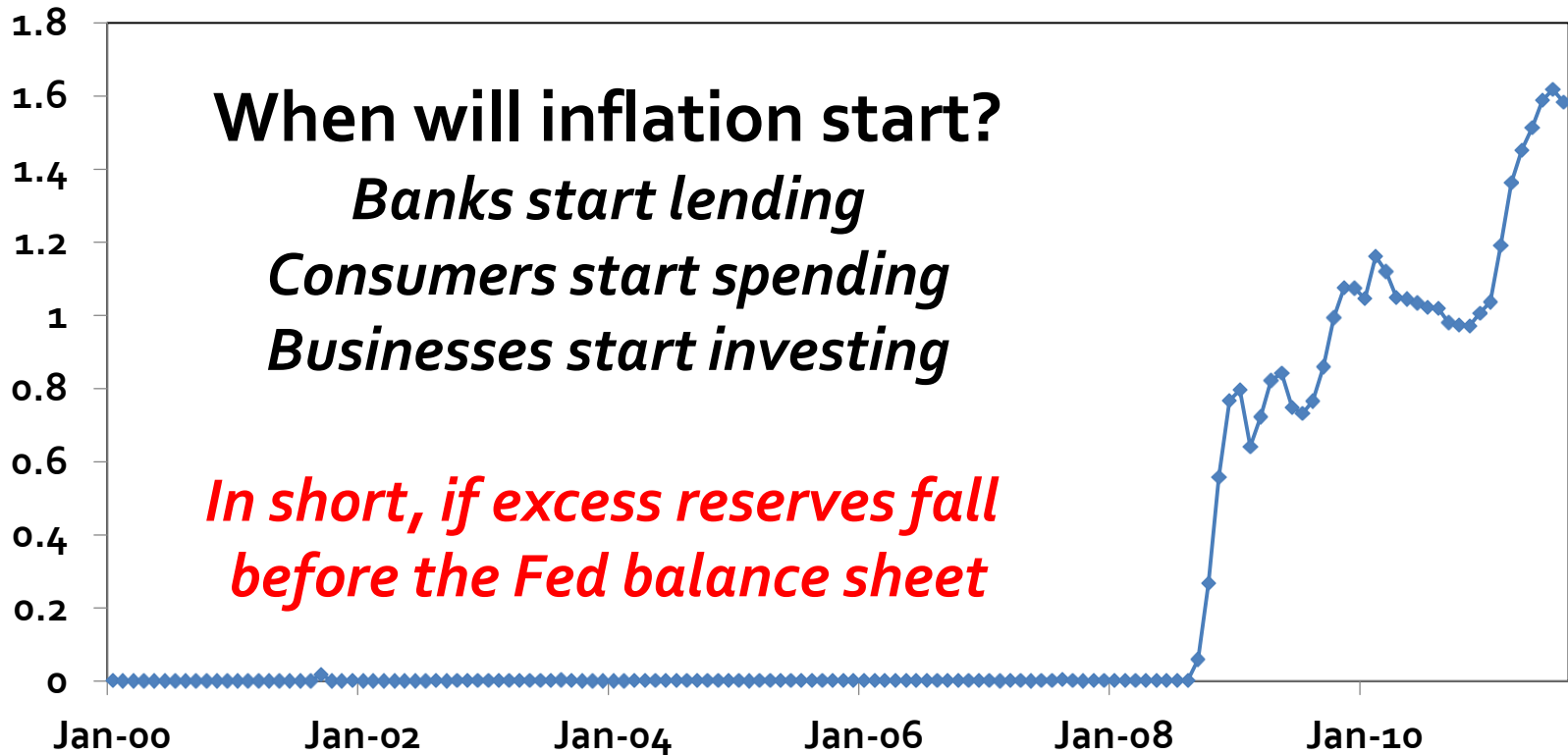
Source: Federal Reserve Board of Governors



Banks are holding monetary base in excess reserves

Excess Reserves in Depository Institutions

Trillion dollars

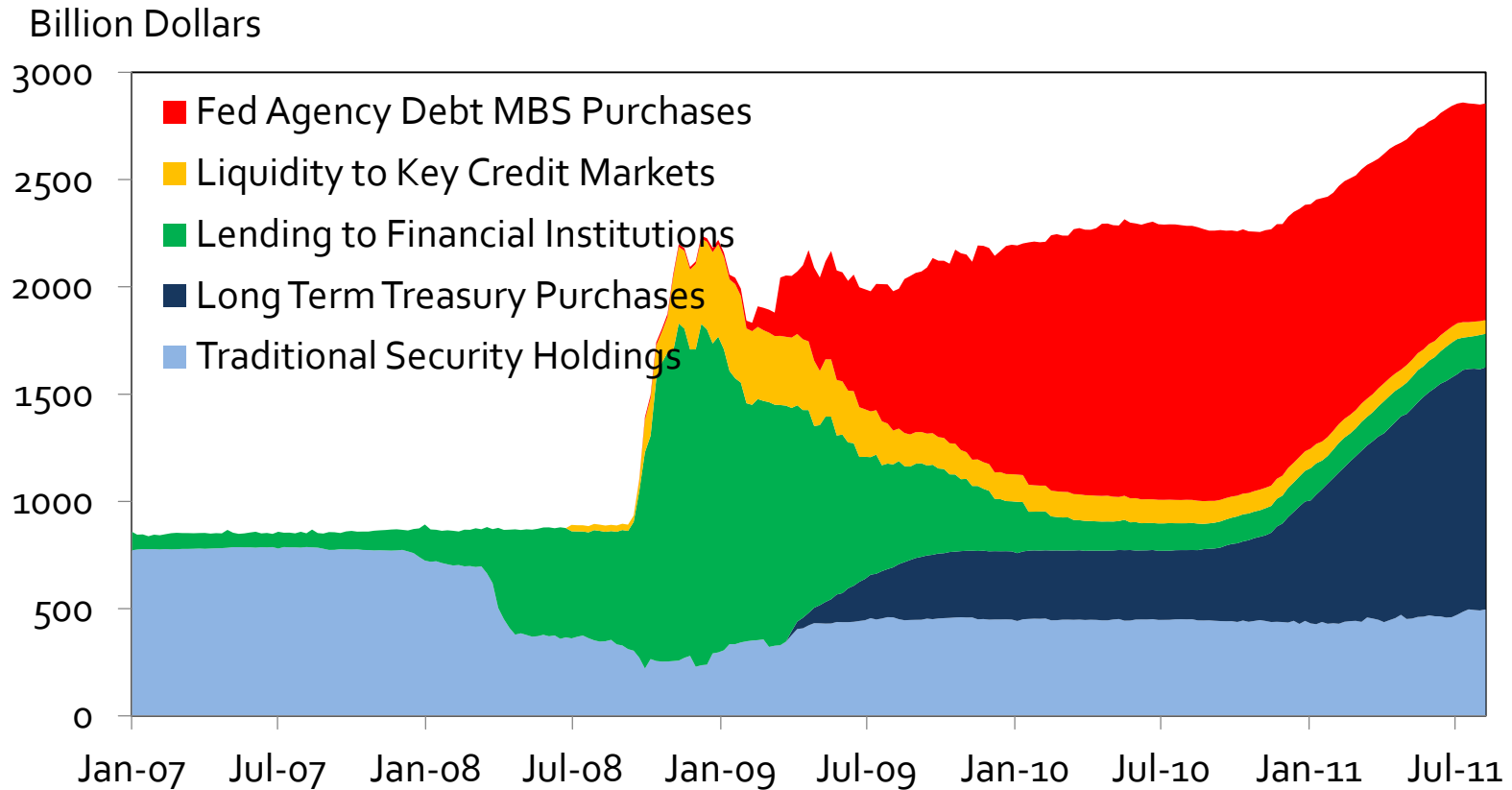


Source: Federal Reserve Board of Governors



What's the exit strategy?

Federal Reserve Balance Sheet: Assets



Source: Federal Reserve Bank of Cleveland



Where are We Now?



The Goal: Foster Maximum Employment and Stable Prices

Economic Projections of Federal Open Market Committee Members, Central Tendency, June 2011

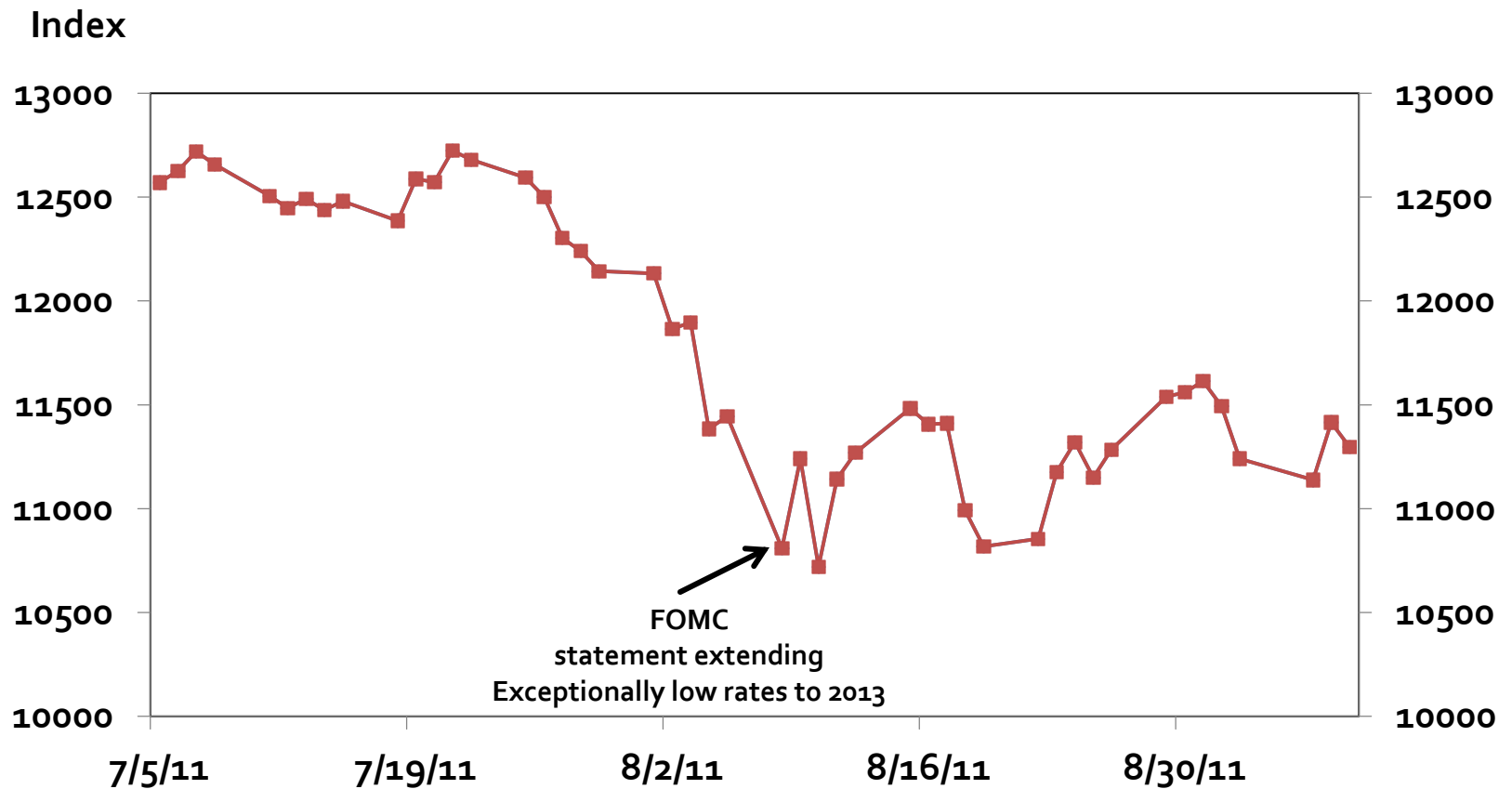
	Longer Run	2011	2012
Real GDP Growth	2.5 to 2.8	2.7 to 2.9	3.3 to 3.7
January 2011 proj.		3.4 to 3.9	3.5 to 4.4
Unemployment Rate	5.2 to 5.6	8.6 to 8.9	7.8 to 8.2
January 2011 proj.		8.8 to 9.0	7.6 to 8.1
PCE Inflation	1.7 to 2.0	2.3 to 2.5	1.5 to 2.0
January 2011 proj.		1.3 to 1.7	1.0 to 1.9

Source: Federal Reserve Board of Governors



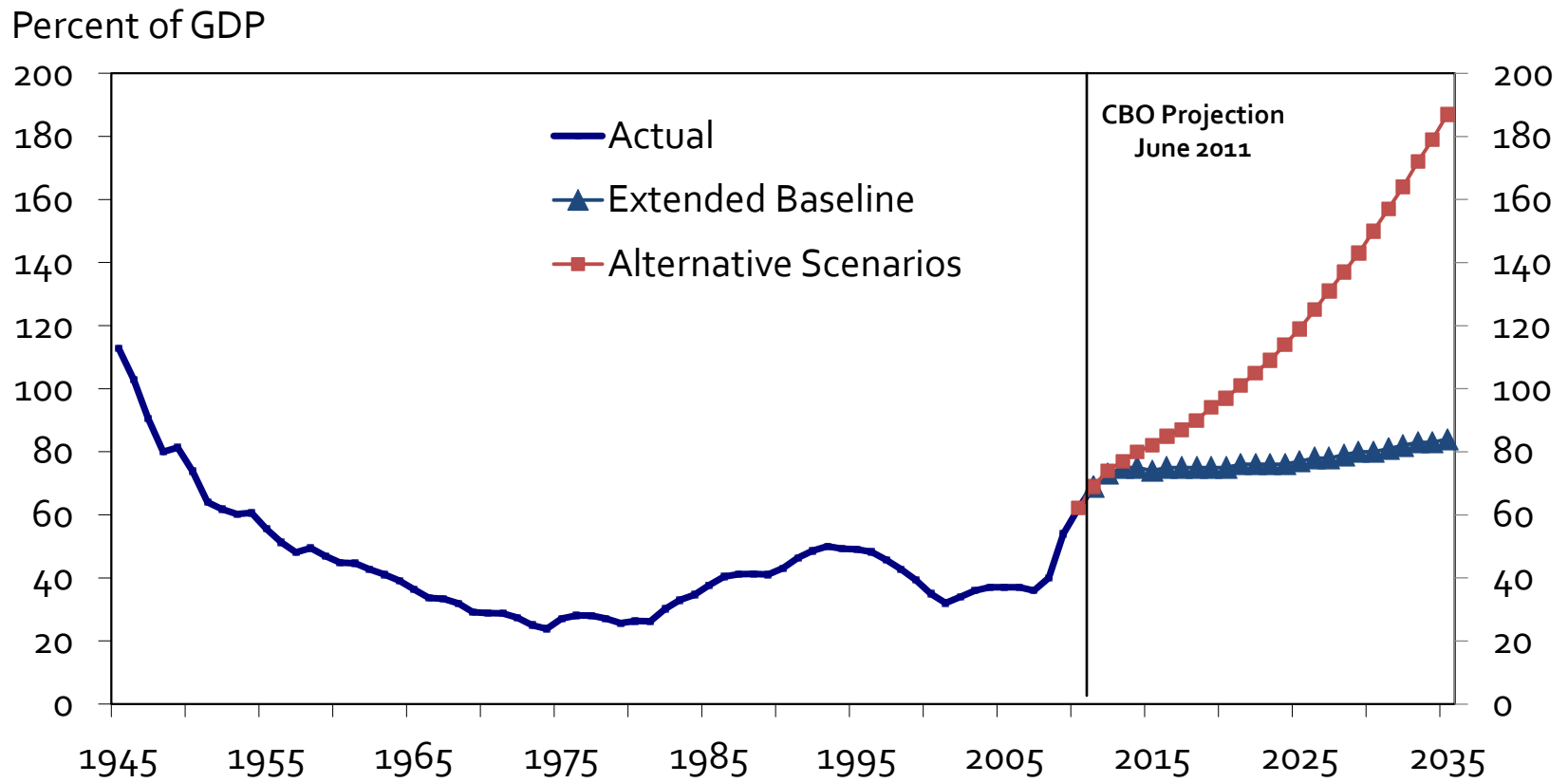
The Panic

Dow Jones Industrial Average



Will the federal government be able to control U.S. debt accumulation?

Federal Government Debt as a Percent of GDP



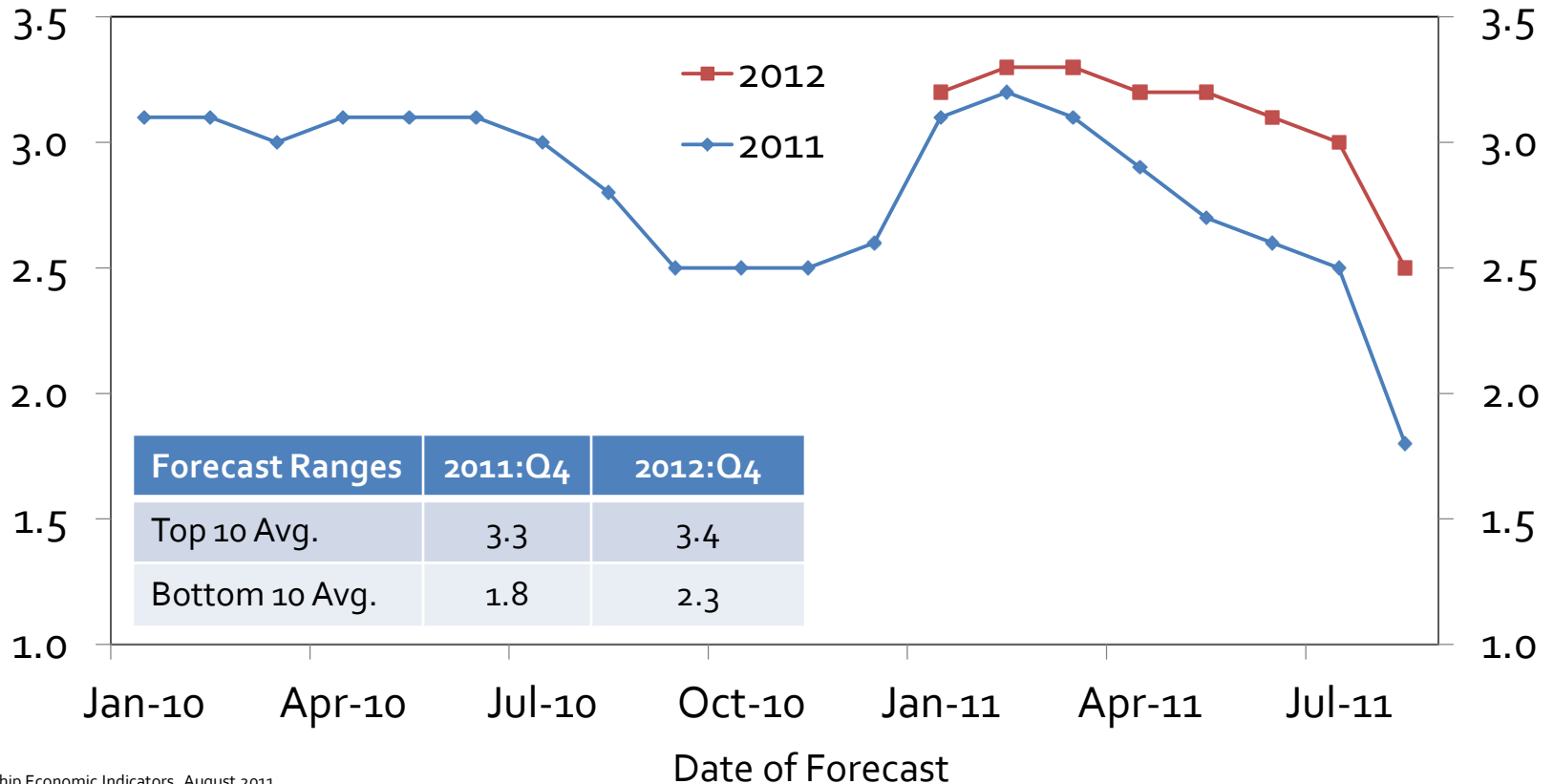
Source: Congressional Budget Office



Economic forecasts dropped sharply in August.

U.S. Real GDP Growth

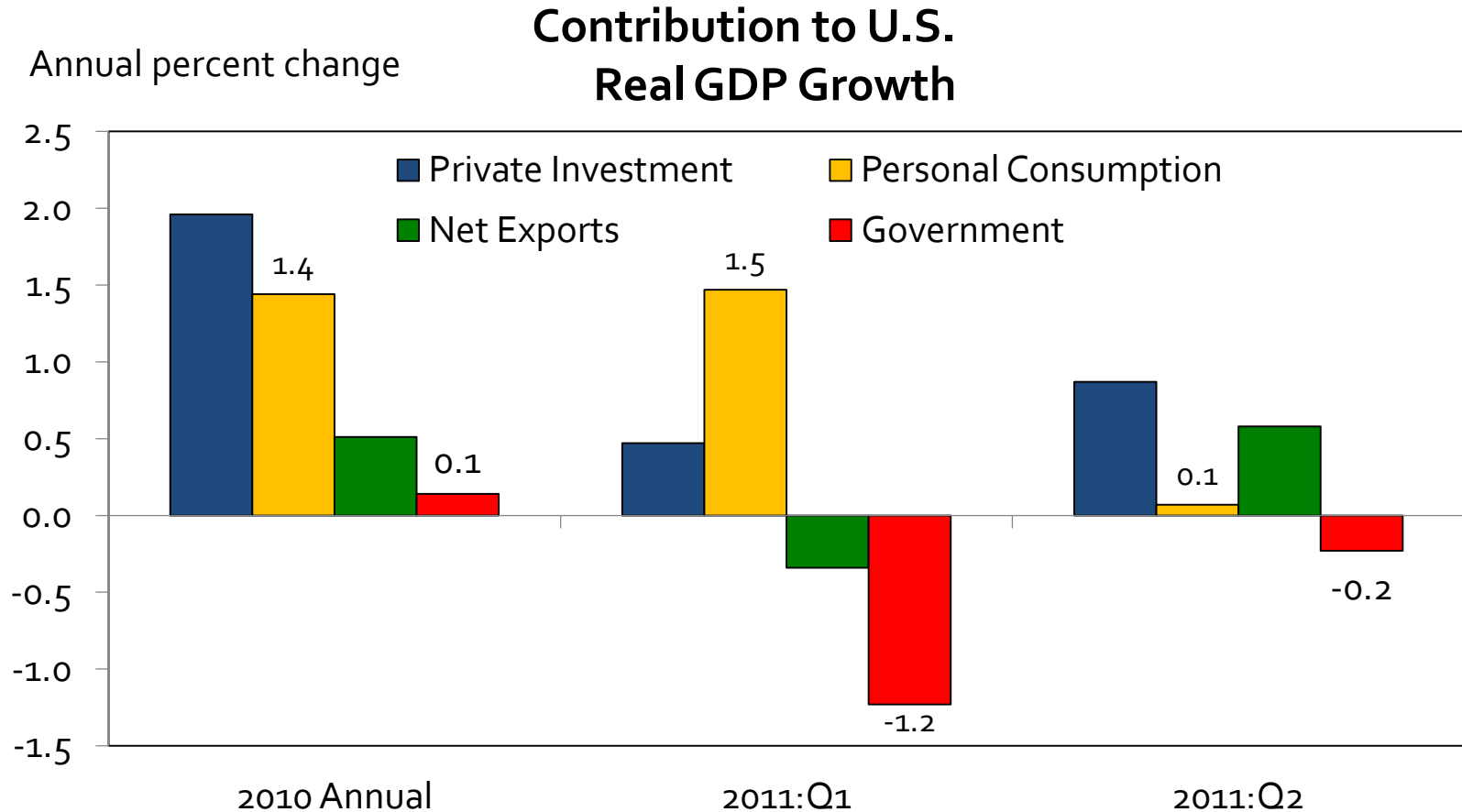
Annual percent change



Source: Blue Chip Economic Indicators, August 2011



Sluggish government and consumer spending.



Source: Bureau of Economic Analysis

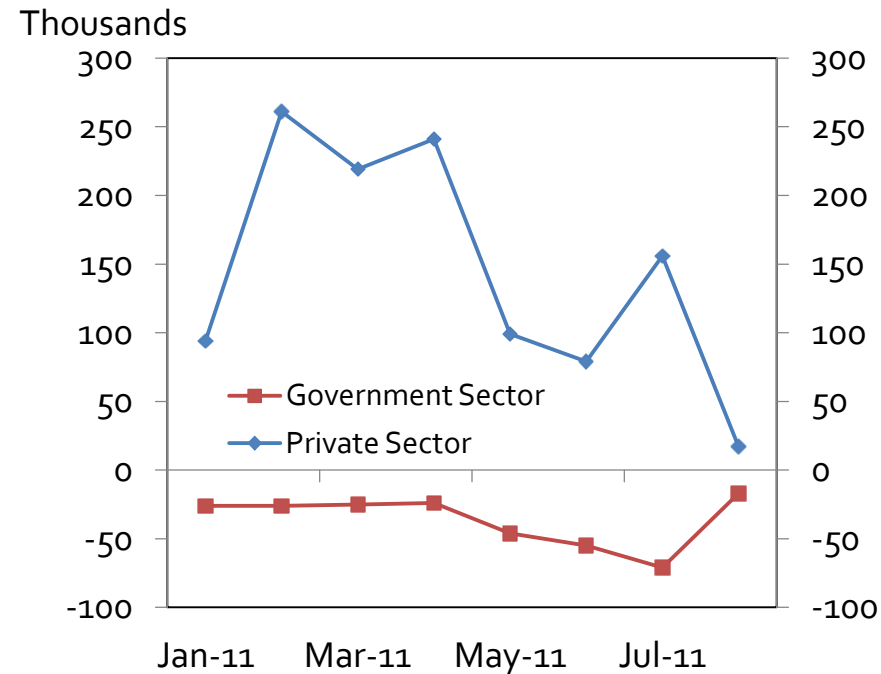


Can the private sector offset a smaller government sector?

What caused the private sector slump?

- Bad weather disrupts U.S. construction
- Supply chain disruptions in Japan
- High input costs - crude oil
- High food and gas prices for consumers
- Mideast turmoil (Arab Spring)
- European Debt Crisis: Greece
- U.S. debt concerns

U.S. Monthly Job Gains



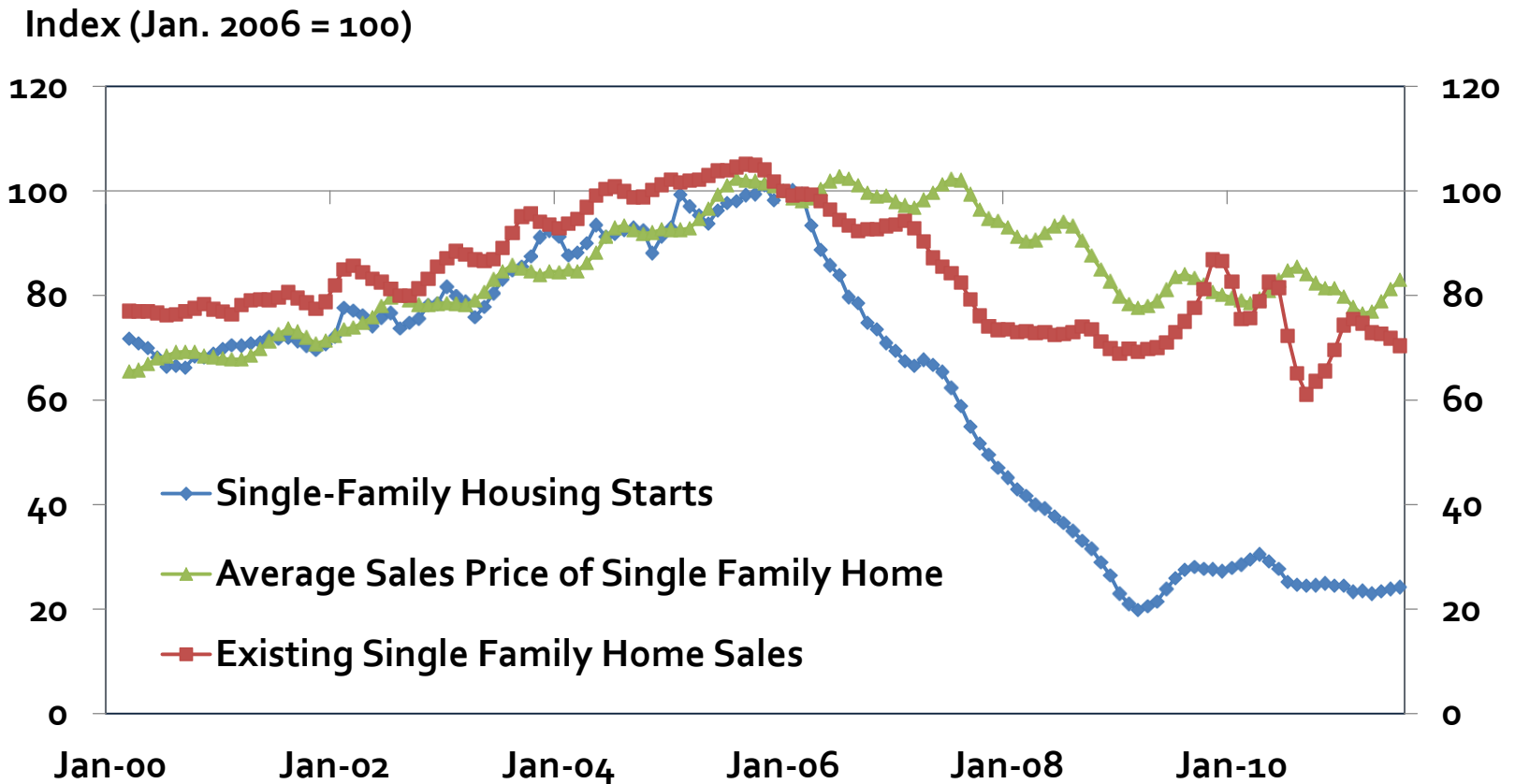
Source: Bureau of Labor Statistics

Structural Versus Cyclical Factors



The housing slump continues.

U.S. Residential Activity

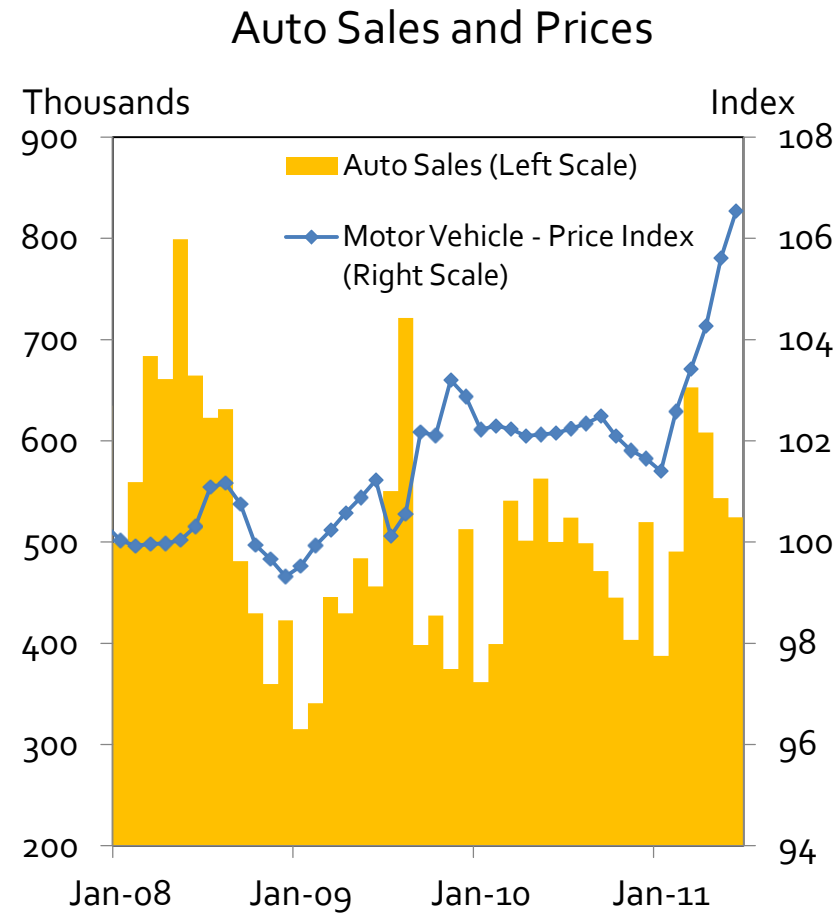


Source: Census Bureau and National Association of Realtors



The U.S. consumer is deleveraging.

- Deleveraging means ...
 - Savings are up.
 - Housing is sluggish.
 - Spending is limited.
- Why?
 - Jobs prospects look bleak.
 - Income gains are modest.
 - Especially for the less-skilled
- Consumers are down, but not out.
 - Rising auto prices indicate consumers are buying.

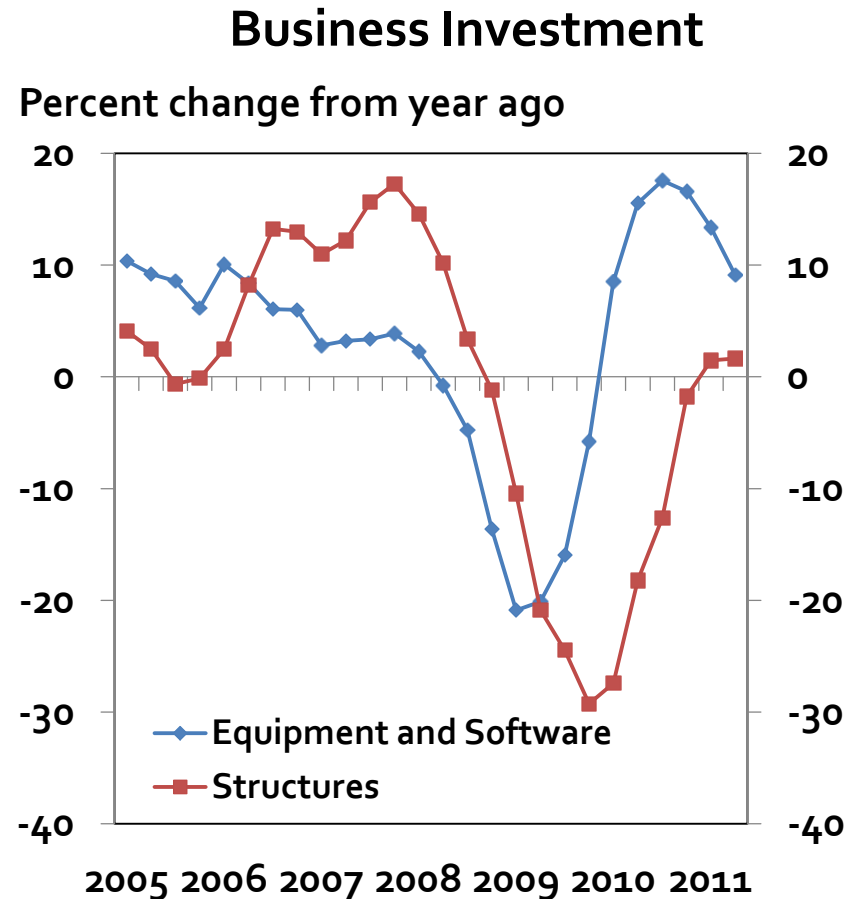


Source: Bureau of Economic Analysis



Slower profits contribute to weaker investment activity and job gains.

- In 2010, profits rebounded sharply.
- Businesses responded by upgrading equipment and software.
- Firms began to expand labor hours –
 - First by extending hours
 - Then by hiring temp workers
- New building activity stabilized.
- In 2011, corporate profits softened.
 - Business investment slowed.
 - Hiring weakened.

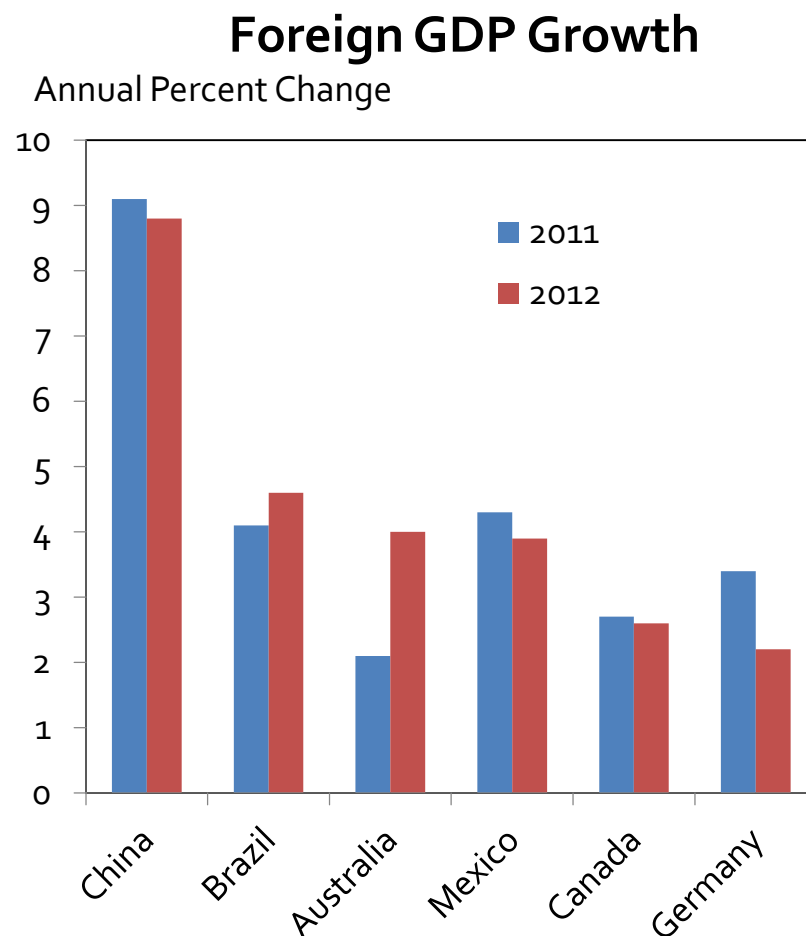


Source: Bureau of Economic Analysis



Global economic growth is mixed.

- A summer slowdown in global economic growth.
- Commodity based economies continue to expand.
- Europe is dealing with their debt issues
- Emerging markets are dealing with inflation.

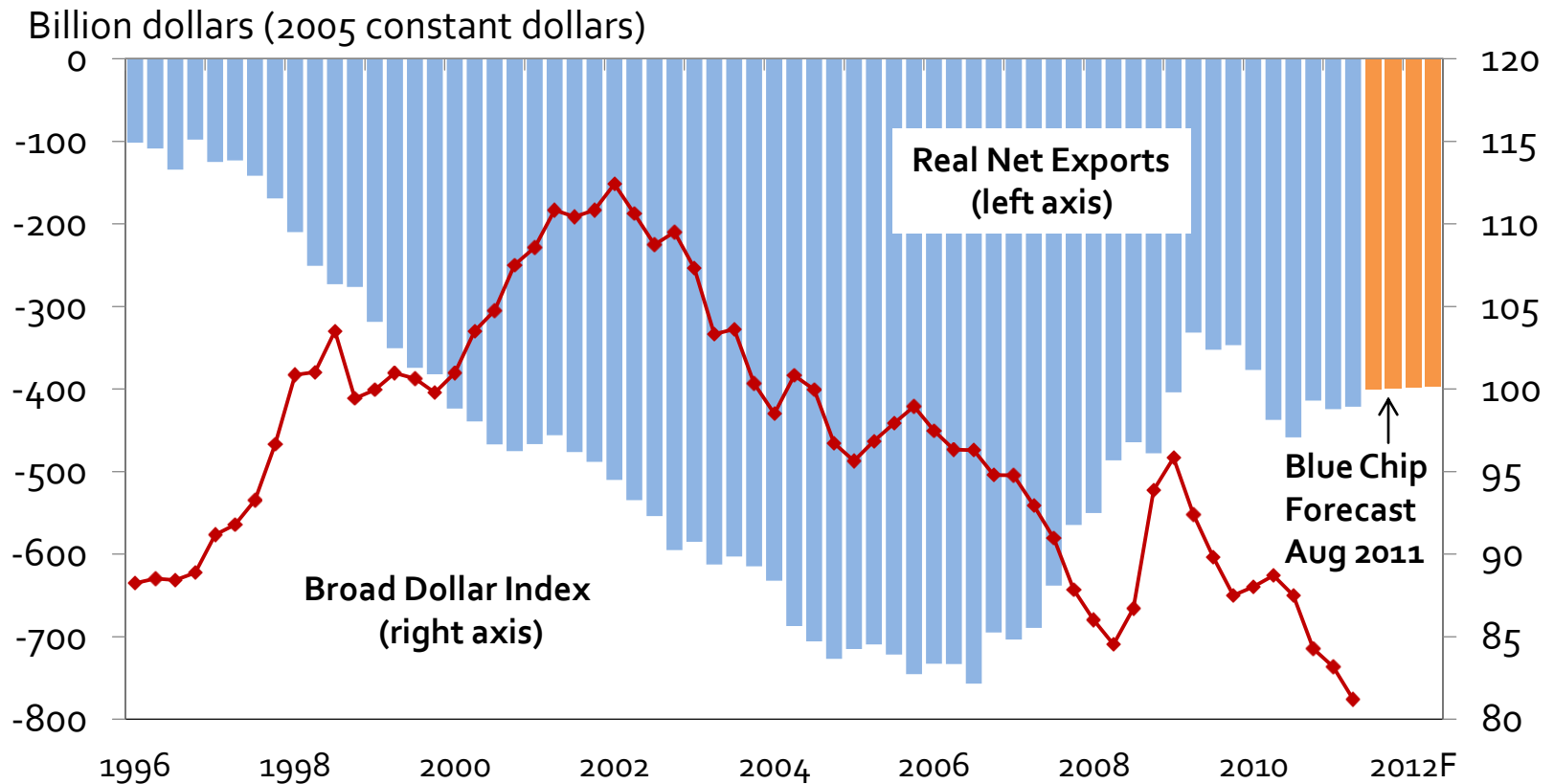


Source: Blue Chip Economic Indicators



Will a weaker dollar cut our trade deficit?

U.S. Real Net Exports of Goods and Services and Value of the Dollar



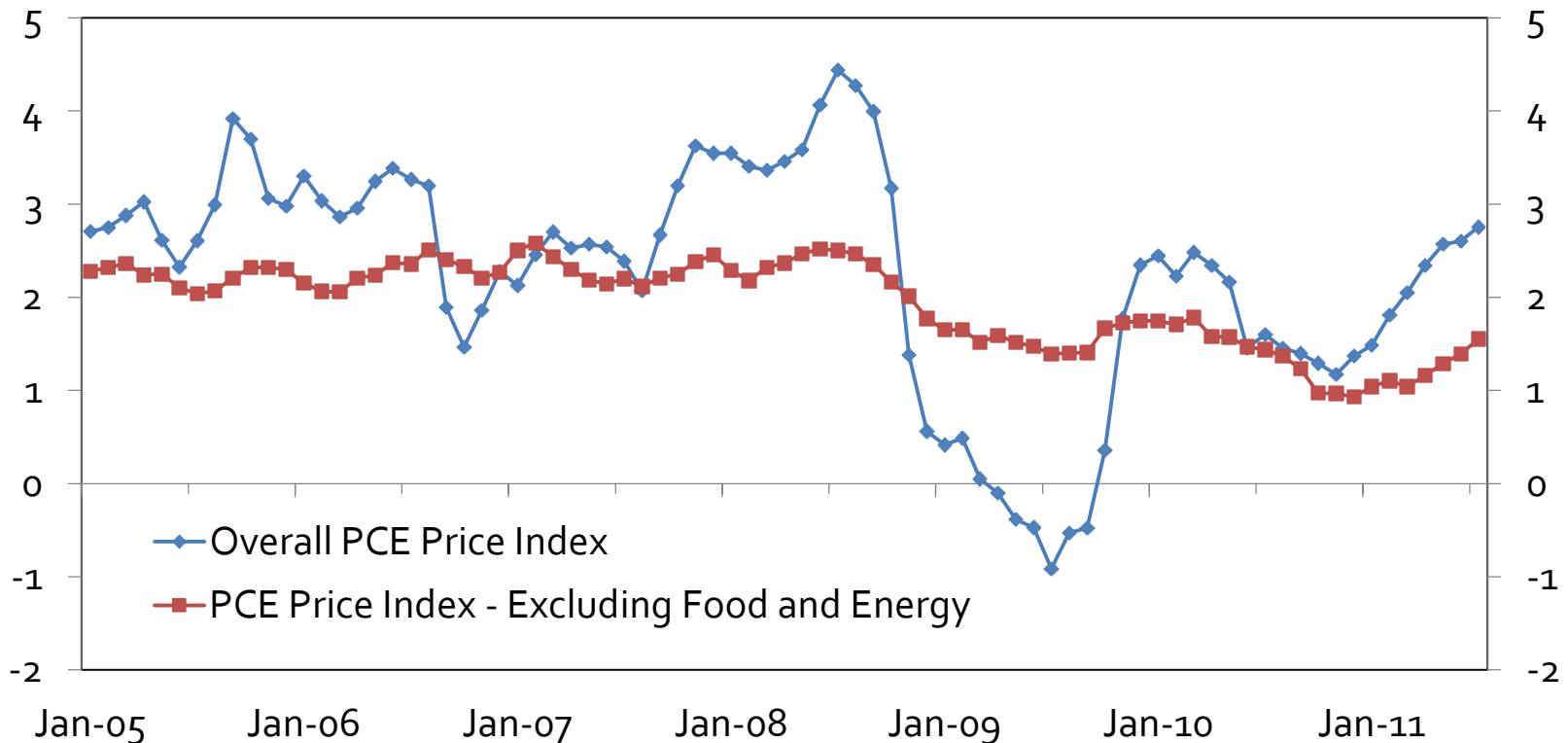
Source: Bureau of Economic Analysis, Federal Reserve Board of Governors, Blue Chip Economic Indicators



What are the inflation risks?

Personal Consumption Expenditures Price Index

Percent change from previous year

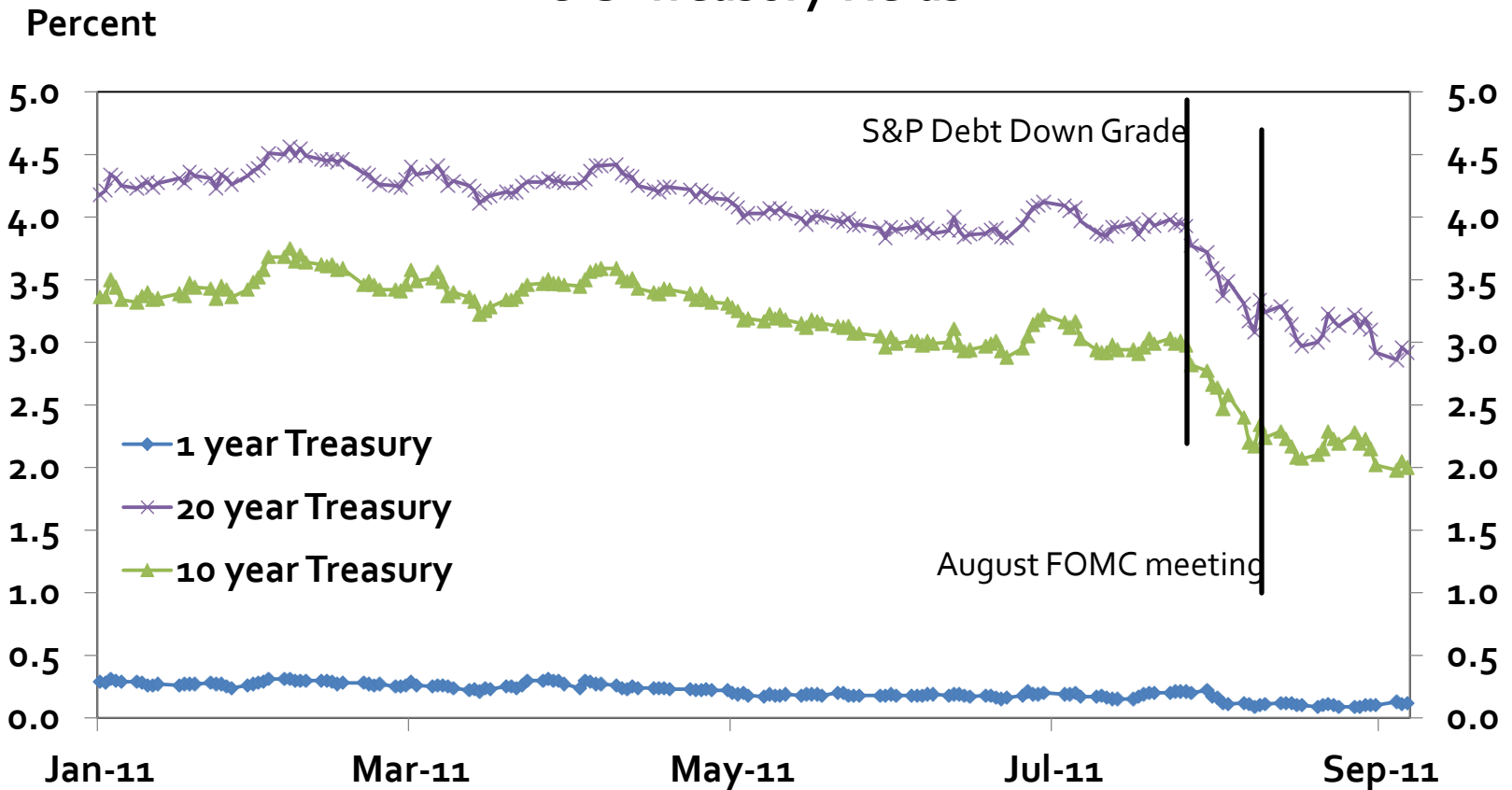


Source: Bureau of Economic Analysis



What is the Goal of QE3 or "Operation Twist"?

U.S. Treasury Yields



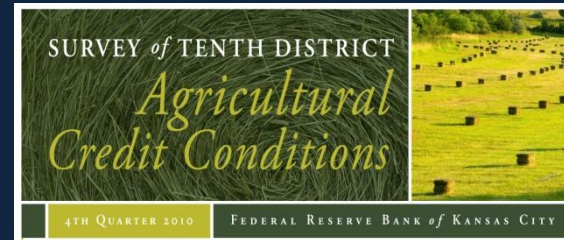
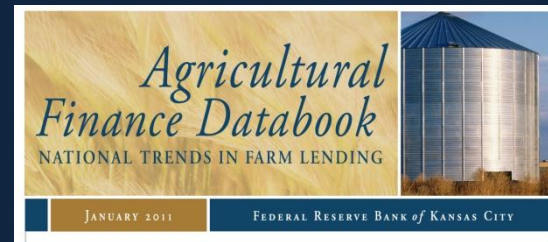
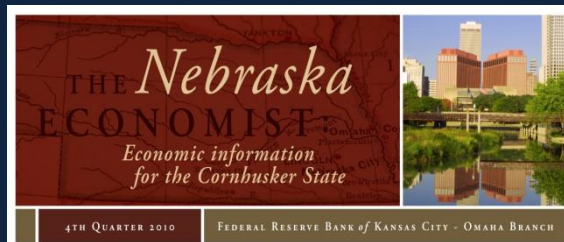
Discussion Questions

- What factors are driving your household spending decisions?
- What factors are driving your business investment decisions?
- How would your business/household respond to lower long-term interest rates?
- Who are the winners/losers and why?
- What will trigger the spark in velocity?



For More Information on The Nebraska Economy and Rural America

www.kansascityfed.org/omaha



Class Assignment: You Make the Call

What is your recommendation to the FOMC?

- 1) Statement on Economic Conditions
- 2) Statement on Monetary Policy Stance
- 3) How would your policy stance help?

