The U.S. Economic Outlook

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The views expressed here do not necessarily represent those of the Kansas City Fed or the Federal Reserve System
Outline

- Structure of the Fed

- Key historical events
  - Creation of the Federal Reserve System
  - Great Depression
  - Great Inflation
  - Great Recession

- Economic update and outlook on Fed policy
Before the Fed

- Two prior attempts to establish a central bank
  - First Bank (1791-1811); Second Bank (1816-1836)
- 19th century banking panics
  - Pre-Fed: 1837, 1857, 1860, 1861, 1873, 1893, **1907**
Creation of the Federal Reserve System

- Fed established in 1913
  - At first, primarily to stabilize banking system
  - Grew into role as nation’s economic manager over time
Structure of the Federal Reserve

- Board of Governors in Washington, DC
  - Independent but within the government
- Twelve regional banks
  - Provide regional input for a national decision
- Four main functions:
  - Facilitate payments
  - Banking regulation
  - Financial stability
  - Monetary policy
The Great Depression

- 1st key event: Fed fails to prevent banks from failing after stock market crash

![Graph showing Dow Jones Industrial Average closing price from 1926 to 1931](Image 1)

3+ years after the market drops

![Bar chart showing Bank Failures in the 1920s and 1930s](Image 2)

Source: The Great Depression by Murray Rothbard

Source: Dow Jones
The Great Depression

- Vulnerability in banks: ST liabilities but LT assets
- Walter Bagehot’s rule for central banks (Lombard Street, 1873):
  - Lend freely to a failing bank
  - At a penalty rate
  - On good (in normal times) collateral
  - Resolve underwater institutions swiftly
- Saving illiquid but not insolvent institutions prevents one failure from making many.
The Great Depression

- Fed fails to respond forcefully to economic downturn

Source: Historical Statistics of the United States
The Great Inflation

- 2nd key event: Fed pushes too hard on the gas

![Graph showing Unemployment rate and "Natural" rate of unemployment from 1960 to 1975. The graph is annotated with "Overheating" and shows a peak in 1974.]

Source: Bureau of Labor Statistics, Congressional Budget Office
The Great Inflation

...resulting in soaring inflation

Source: Bureau of Economic Analysis
Great Recession

- **3rd key event: Asset price boom goes bust**

Index, Jan 1995 = 100

Source: CoreLogic
Great Recession

- Did accommodative Fed policy fuel the bubble?

Source: Federal Reserve Board

[Graph showing Federal funds rate and Taylor Rule over time from 2000 to 2006, with a note indicating that the rate was too low during a certain period.]
Great Recession

- Economic output falls below economy’s full potential

Source: Bureau of Economic Analysis, Congressional Budget Office
Great Recession

- Millions of people lost jobs; unemployment soars

Source: Bureau of Labor Statistics
The Great Recession

- Fed determined to prevent another Great Depression
- But also worried about another Great Inflation
- Or another asset bubble
• Fed’s drops target rate to zero

Source: Federal Reserve Board
Federal Reserve Response II

- Massive effort to stabilize financial system and real economy
  - QE1 and QE2 specified amounts, QE3 conditional on economic progress

![Graph showing asset purchases and financial stability measures from 2007 to 2015](source: Federal Reserve Board)
Federal Reserve Response III

• Communication used to be very opaque

• FOMC provides forward guidance on policy
  o Tied explicitly to the state of economy

• “Disclosure of the directive would be more misleading to the market than no information at all”
Effects of Fed Policy

- Fed is probably pushing down interest rates for consumers

Source: Federal Reserve Board, New York Times
• Auto sales have recovered; housing construction has not

Source: Bureau of Economic Analysis, Census Bureau
Effects of Fed Policy

- Fed could be incentivizing a dangerous reach for yield

Source: Bank of America
Effects of Fed Policy

- Inflation has remained tame and expectations well anchored

Source: Bureau of Labor Statistics
Economic Recovery

- Fed’s efforts may be paying off but costs are uncertain

**Thousands, 3 mo. avg. change**

*Source: Bureau of Labor Statistics*
Economy is on track for above trend growth.
Markets expect the Fed to hike rates later this year.
Fed Policy

Key question: how far away from normal are we?

Source: Bureau of Economic Analysis, Congressional Budget Office
Fed Policy

- Unemployment suggests recovery is almost complete

Source: Bureau of Labor Statistics
Fed Policy

- Labor force participation suggests it has a ways to go

Source: Bureau of Labor Statistics
Wages likewise suggest economic slack remains

Source: Bureau of Labor Statistics
Recent financial developments complicate things.

Source: Dow Jones, JP Morgan
Fed Policy

- Will the normalization of Fed policy go smoothly?

![Graph showing stock market volatility index from 2010 to 2015]

- Flash Crash, summer swoon
- Debt ceiling, Greece
- Oil shock, post-QE uncertainty

Source: Wall Street Journal
Questions?

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