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Five Questions on U.S. Monetary Policy

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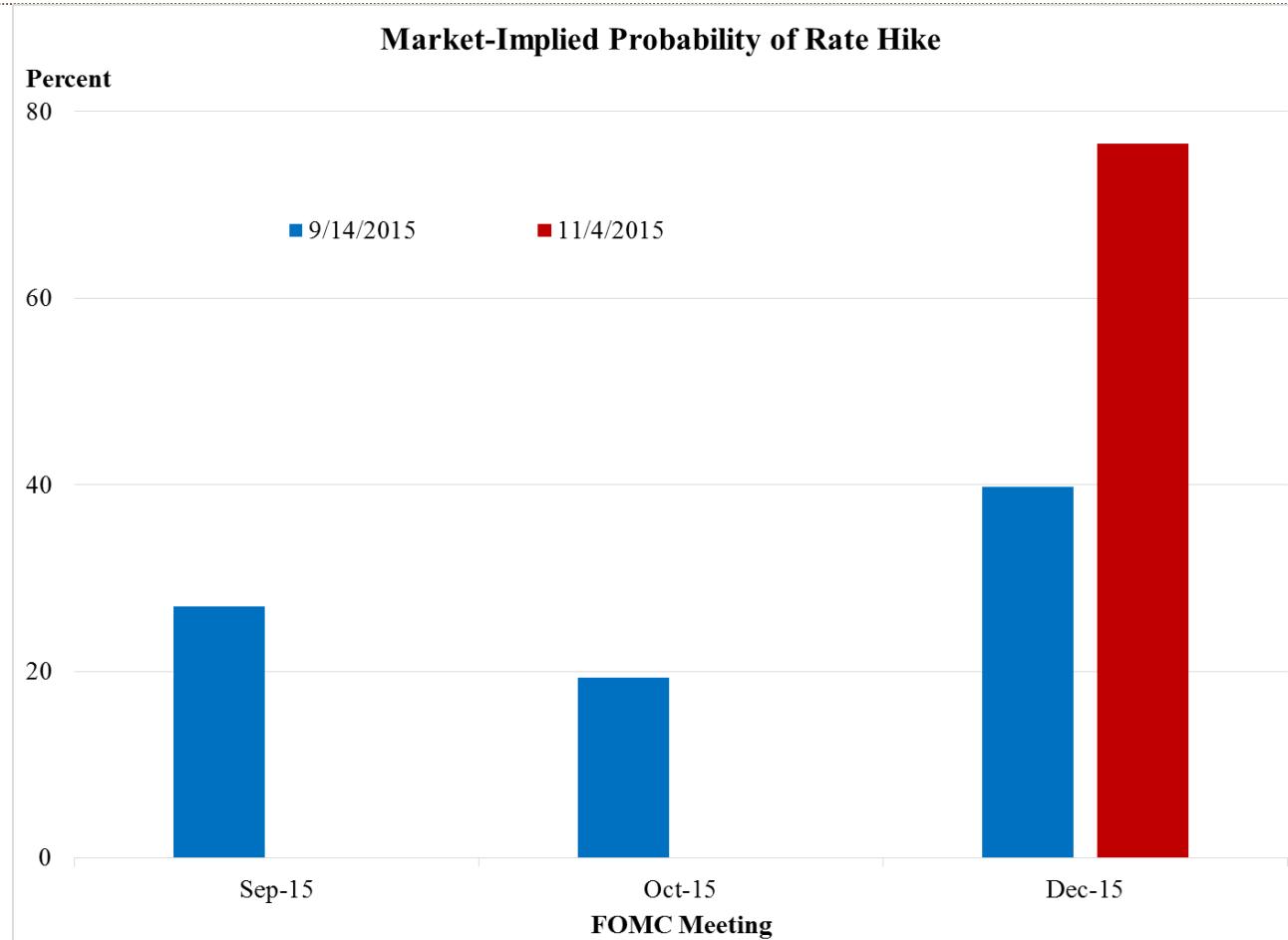
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Introduction

The current situation

- The FOMC has said that 2015 would be a time to consider a gradual increase in the policy rate from near-zero levels—the so-called “ZIRP.”
- The Committee did not move in September, citing global factors.
- In October, the Committee removed the key sentence citing global factors and suggested that the ZIRP policy could be ended soon, depending on incoming data.
- The market-based probabilities of a near-term end to ZIRP have increased.

The probability of ending ZIRP soon



This talk

- While any decision will be data dependent, as always, some key questions loom for the FOMC.
- I will discuss some of these.

The five questions

- What are the chances of a hard landing in China?
- Have U.S. financial market stress indicators worsened substantially?
- Has the U.S. labor market returned to normal?
- What will the headline inflation rate be once the effects of the oil price shock dissipate?
- Will the U.S. dollar continue to gain value against rival currencies?

Reduced Global Uncertainty

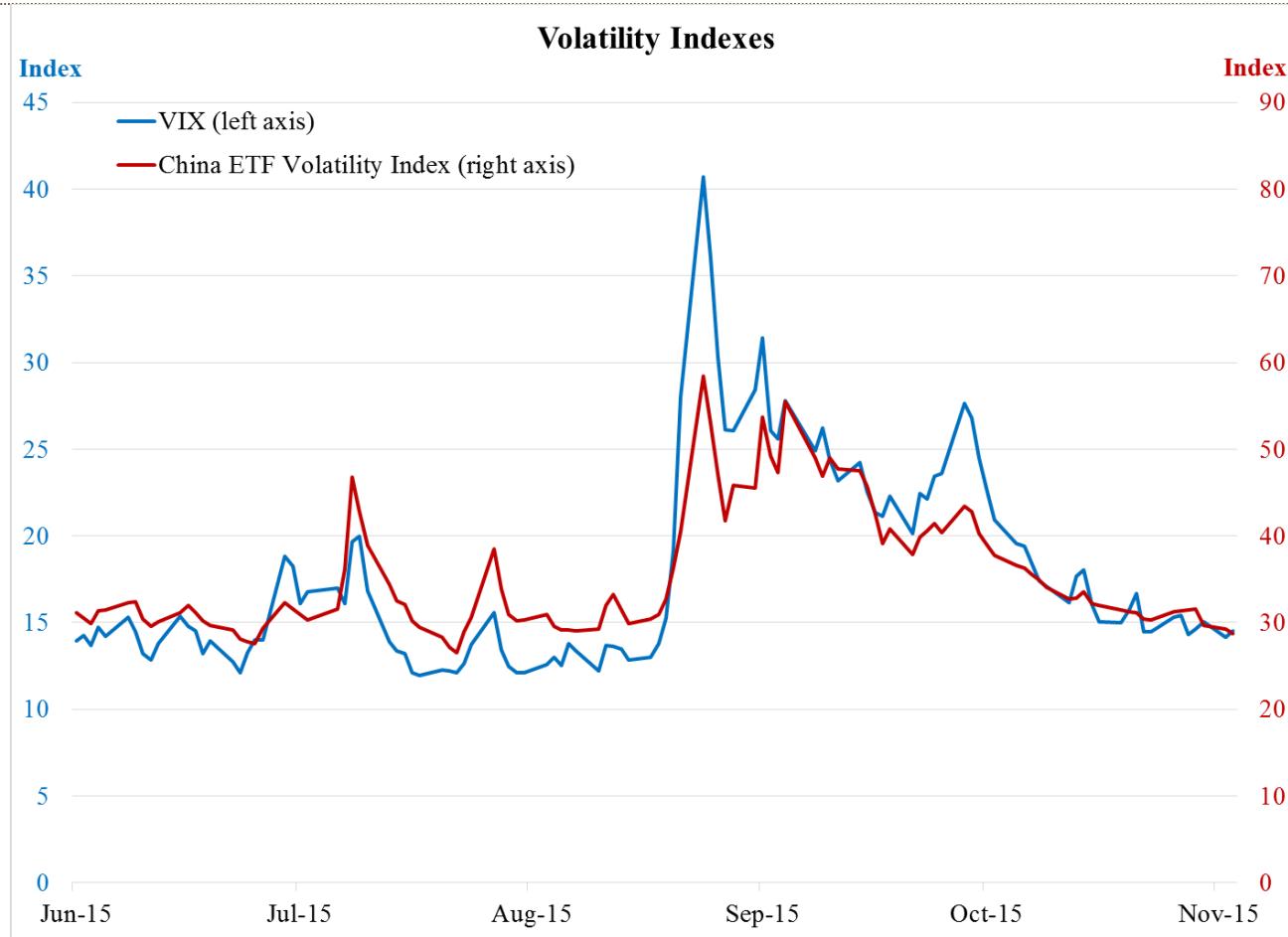
Reduced global uncertainty

- The October 28 FOMC statement made the following change:
 - ~~Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term.~~
 - The Committee continues to see the risks to the outlook for economic activity and the labor market as nearly balanced but is monitoring **global economic and financial** developments **abroad**.

A hard landing in China?

- The fear developed in financial markets during August 2015 that China might experience a hard landing; that is, a sharp fall in the growth rate to zero or lower.
- This, it was feared, might presage additional weakness in emerging markets, and eventually spill over to the U.S.
- However, this fear dissipated when China's Q3 growth was reported at 6.8 percent. In addition, the IMF did not meaningfully downgrade China's macroeconomic outlook.
- Volatility indexes now suggest that the probability of a hard landing in China has returned to pre-August levels.

Volatility indexes

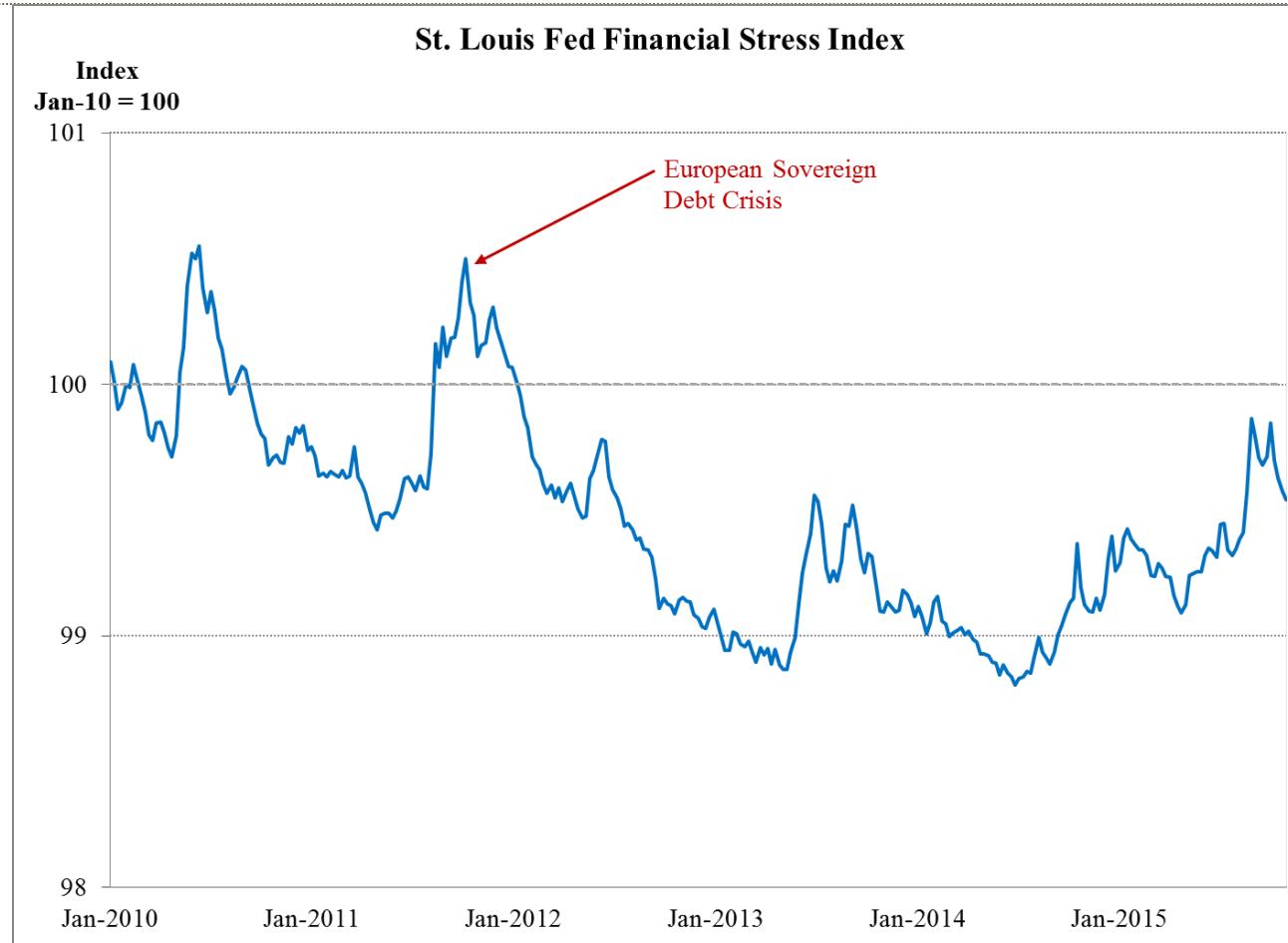


Improved U.S. Financial Conditions

Improved U.S. financial conditions

- The China scare drove up U.S. financial market volatility during August and September 2015.
- Does this mean that the level of financial stress in the U.S. remains high today?
- One way to address this question is to consider a financial stress index that has components like volatility measures and interest rate spreads.
- The St. Louis Fed Financial Stress Index does not show particularly high levels of stress currently.

St. Louis Fed Financial Stress Index

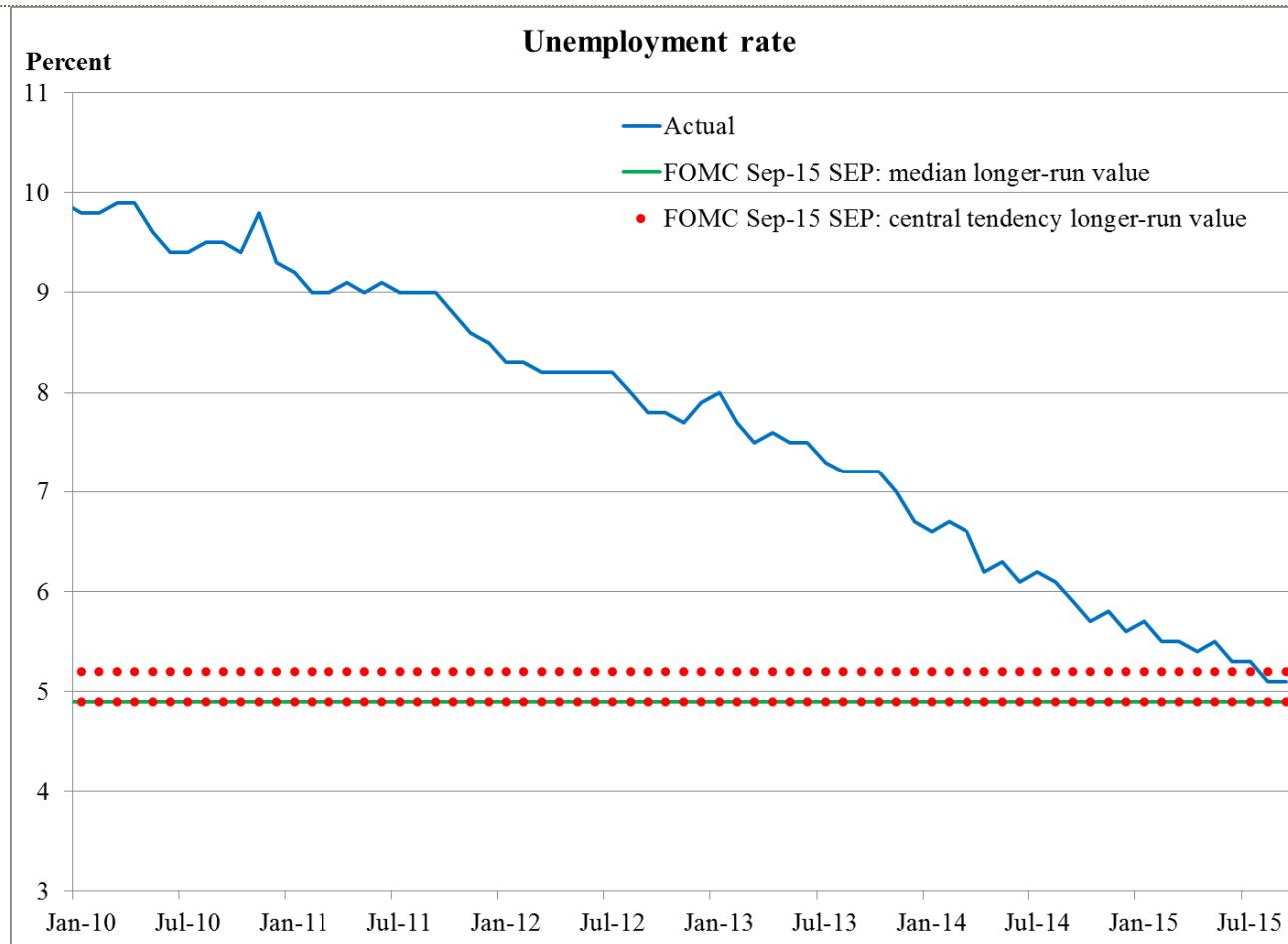


Cumulative Progress in U.S. Labor Markets

Unemployment

- The unemployment rate has fallen faster than the FOMC expected.
- The unemployment rate, at 5.1 percent in September, is within the Committee's central tendency of the estimate of the longer-run rate.
- Given the uncertainty around this estimate, 5.1 percent is statistically indistinguishable from the value of the longer-run rate.

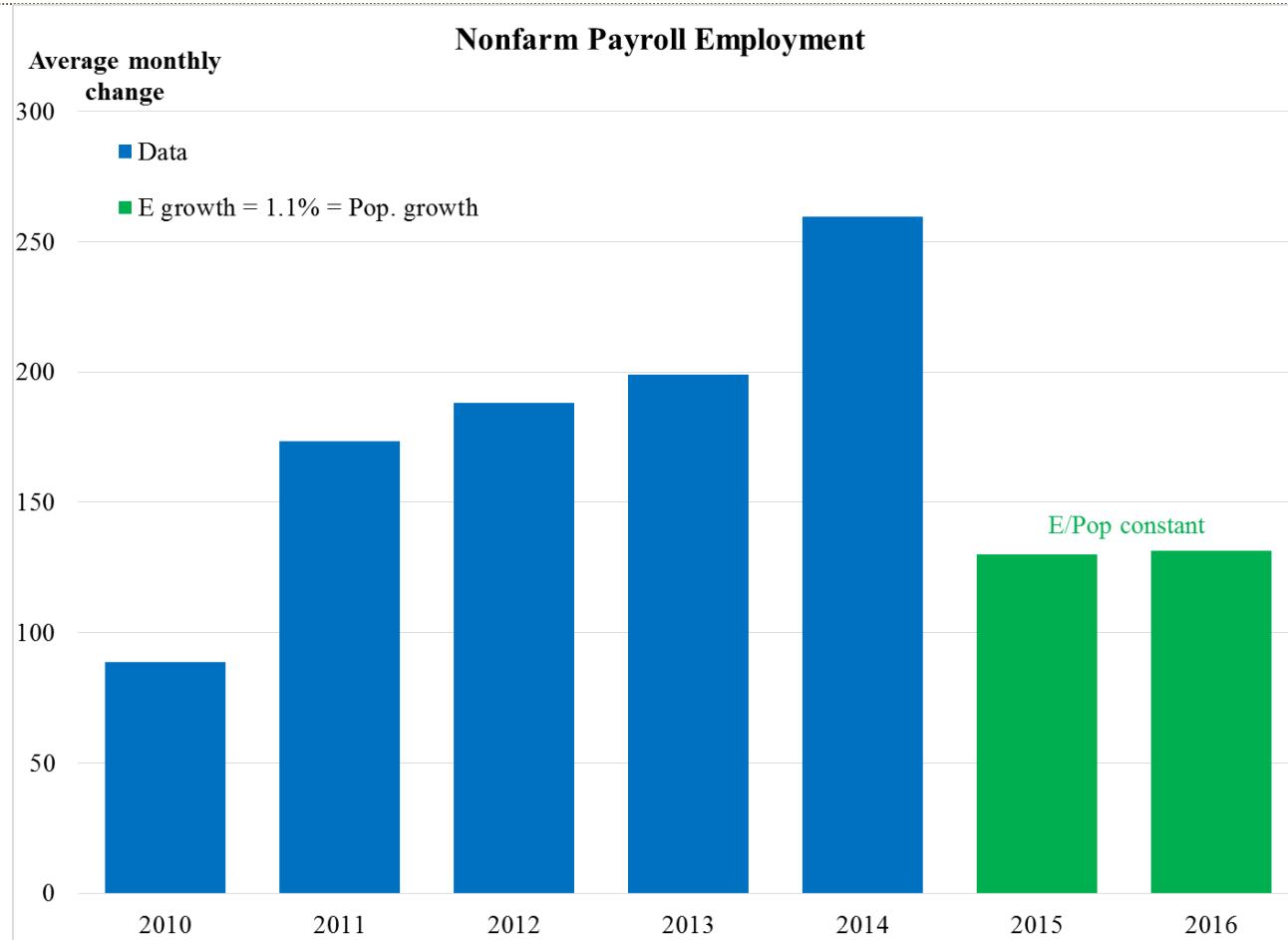
Unemployment relative to Fed objective



Job creation

- Nonfarm payroll employment has also increased faster than anticipated.
- Roughly 1 million more jobs have been added relative to private sector forecasts as of September 2012, the date of the launch of QE3.
- Job creation is expected to slow going forward as the economy continues to normalize.
- Even with job creation as low as 130,000 per month, the employment-to-population ratio would remain constant.

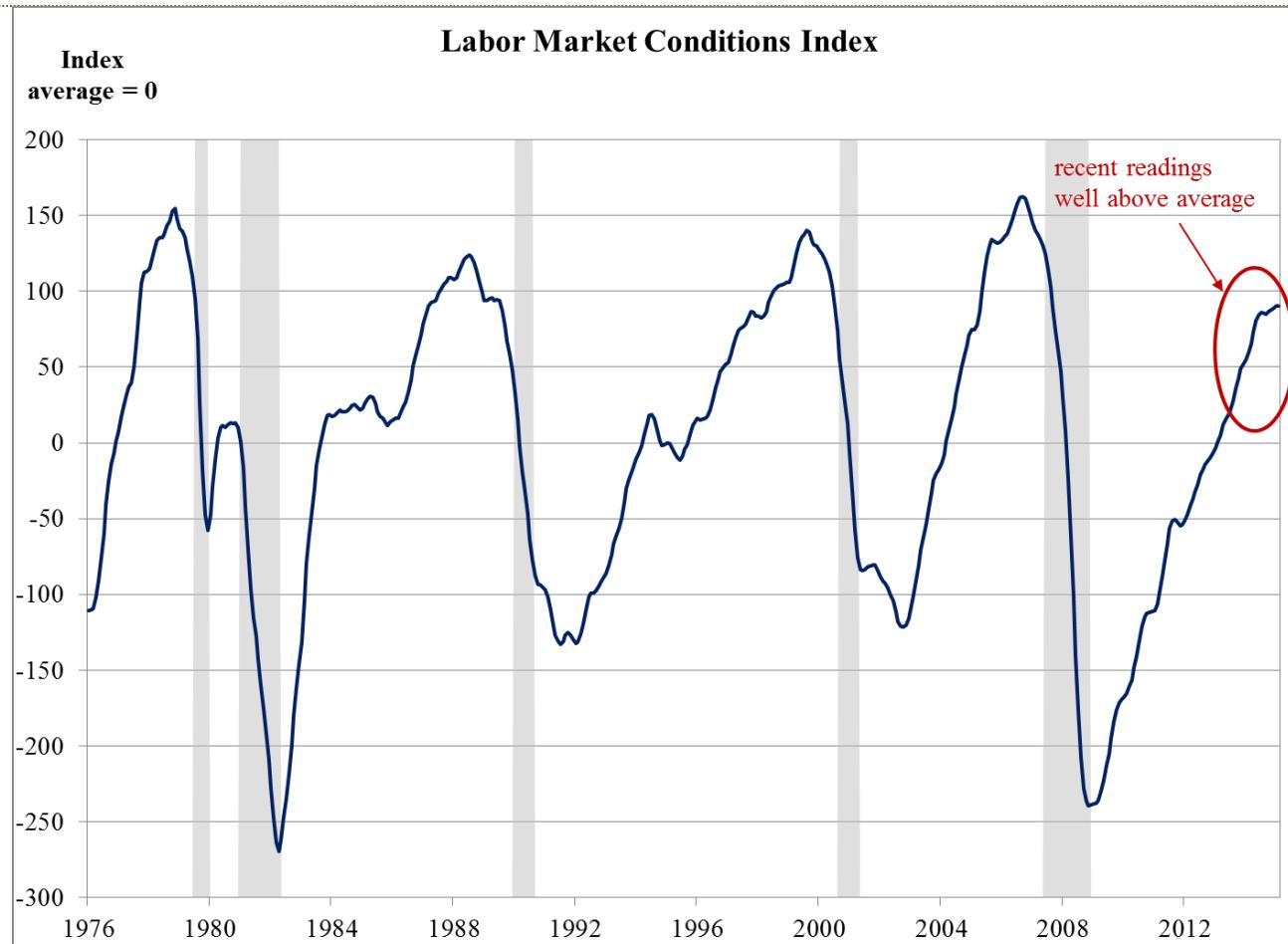
Job creation expected to slow



Alternative measures of labor market performance

- What about alternative metrics for labor market performance?
- Some, like job openings and initial claims for unemployment insurance, look very good, while others, like part-time for economic reasons and long-term unemployment, look weak.
- One way to get a handle on this issue is to consider a labor market conditions index (LMCI).
- The St. Louis Fed has calculated the level of a well-known LMCI.[†]
- Its value is well above historical norms, indicating excellent labor market health.

LMCI indicates a healthy labor market

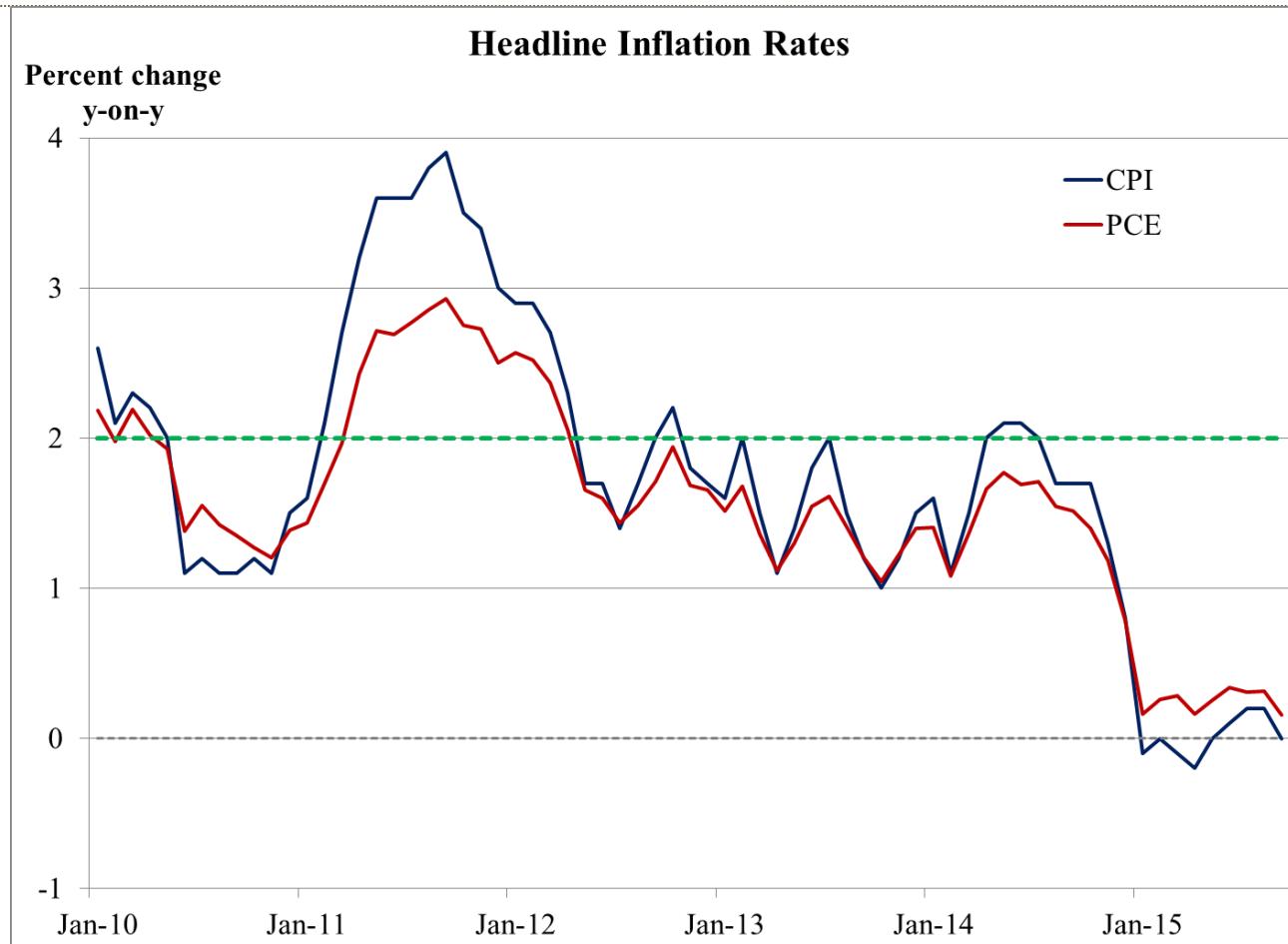


Inflation Once Oil Prices Stabilize

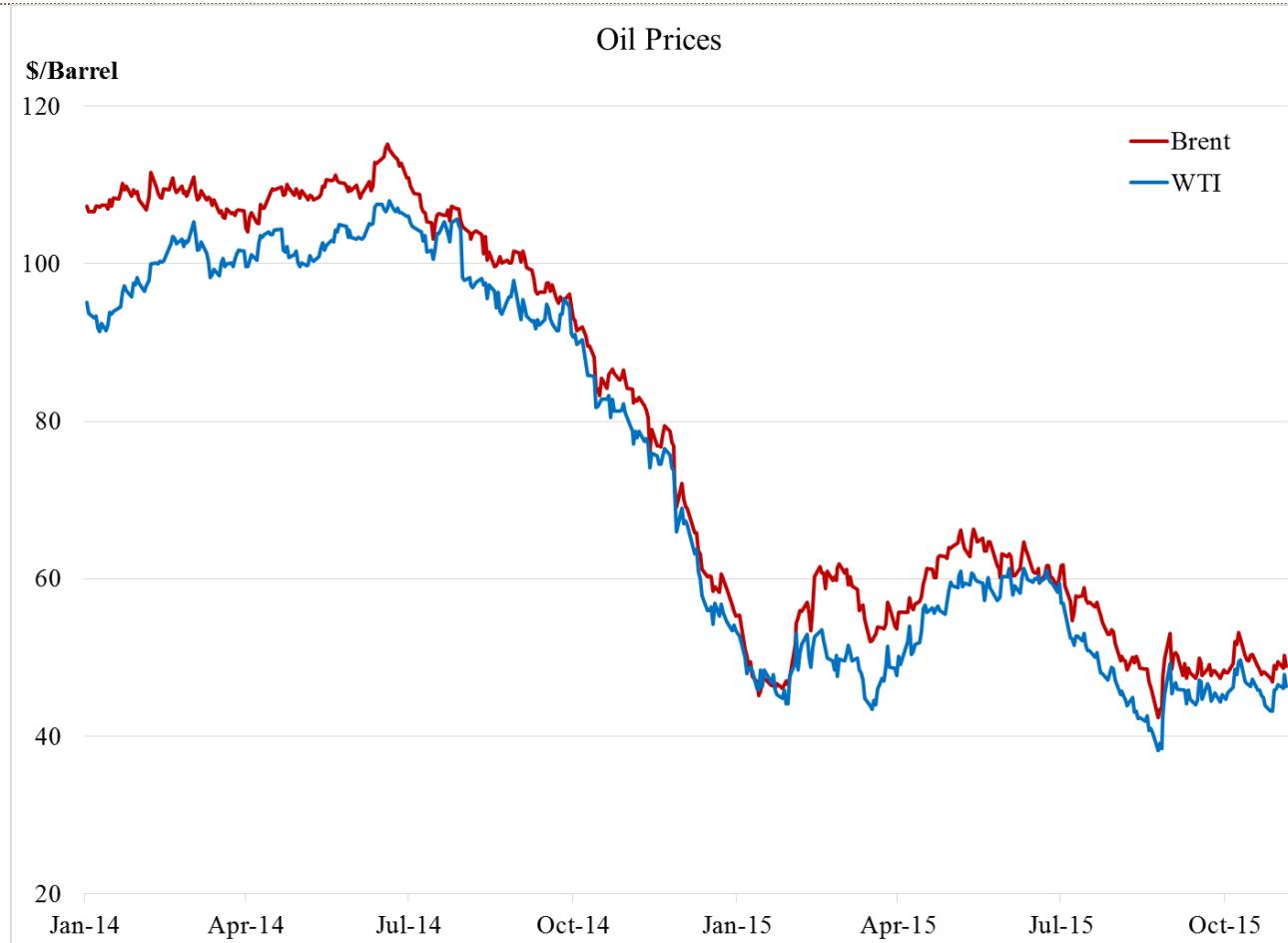
Headline inflation seems very low

- Headline inflation measured from one year ago is very low.
- However, this is due in part to a very large drop in the dollar price of oil beginning in mid-2014.

Headline inflation



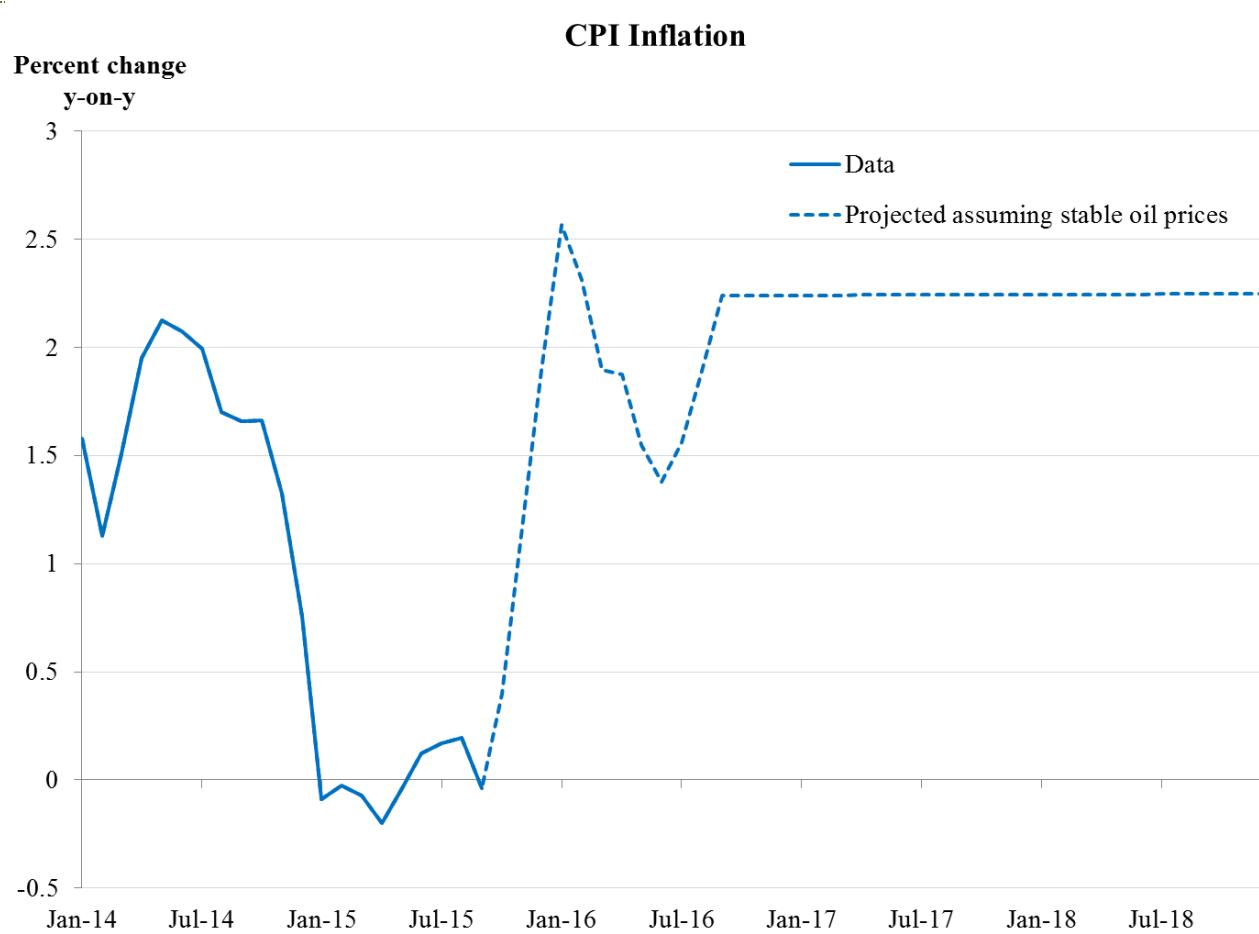
Oil prices



Headline inflation once oil prices stabilize

- The fall in oil prices has only a one-time influence on the year-over-year inflation rate.
- Let's suppose that oil prices stabilize at the current level and stay around that level for several years.
- Let's further suppose that all other prices continue to increase at the same pace as they have during 2015 so far.
- What would the headline CPI inflation rate be at the end of 2016 under such a scenario?
 - Answer: More than 2 percent.

Headline inflation once oil prices stabilize



Source: Bureau of Labor Statistics, Energy Information Administration and author's calculations.
Last observation: September 2015.

The Dollar and Global Policy Divergence

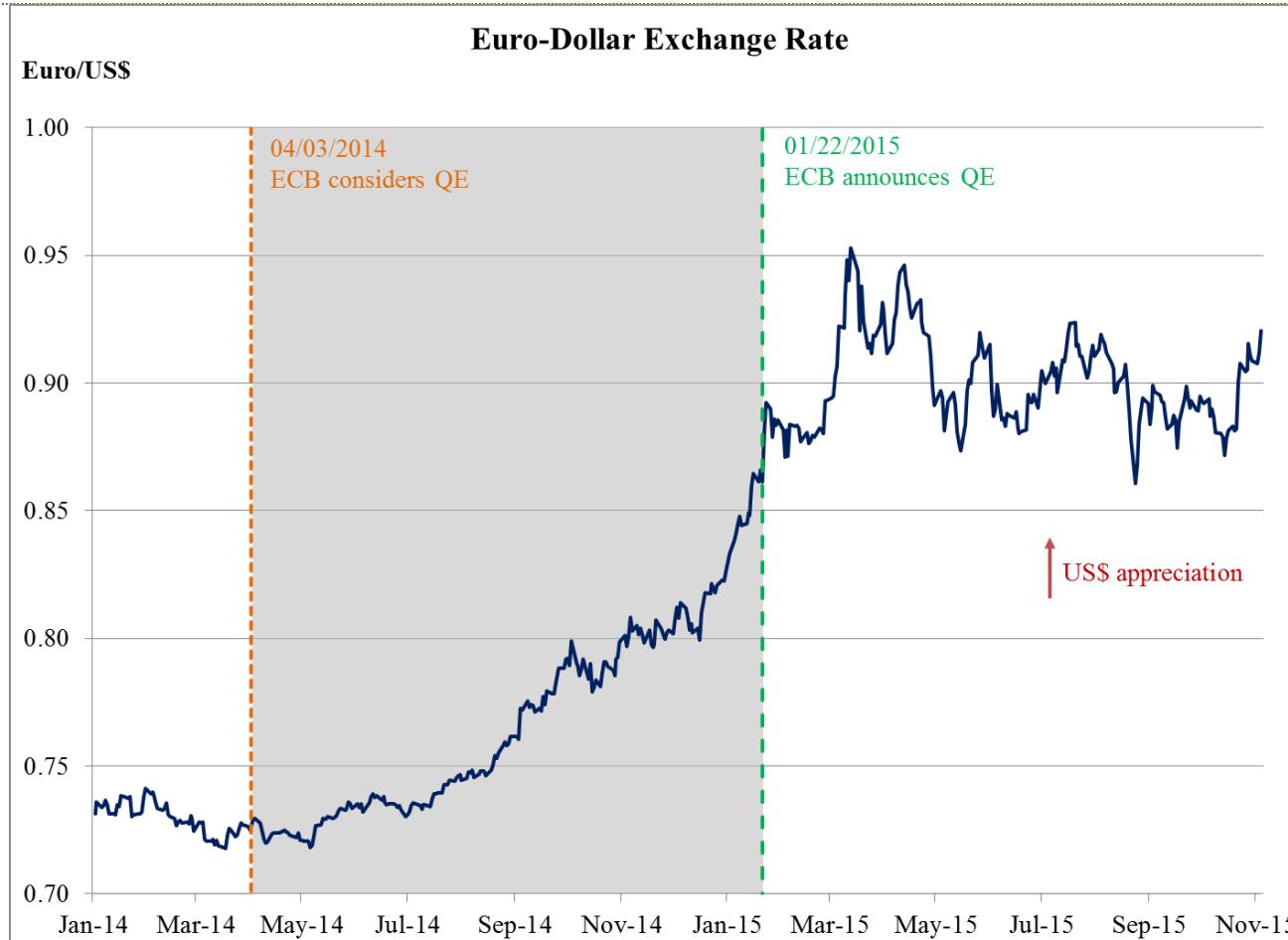
The relatively strong dollar

- The dollar has appreciated on a trade-weighted basis since mid-2014.
- This has generally been viewed as a drag on U.S. economic growth during 2015.
- A key question is whether the dollar will continue to strengthen over coming quarters or not.

Only unexpected developments matter

- Foreign exchange markets are forward-looking and foresee most or all systematic movements in economies, including predictable policy movements.
- A key unexpected event occurred in 2014: ECB quantitative easing.
- At the beginning of 2014, ECB QE was considered very unlikely. However, by the end of that year, it was close to becoming ECB policy.
- This policy surprise drove the euro-dollar exchange rate during 2014.

ECB QE: effect on euro-dollar exchange rate



The future level of the euro-dollar exchange rate

- Many ask whether further sharp movements in the euro-dollar exchange rate are possible.
- The answer is yes, but only based on unanticipated movements in the economies of the U.S. or Europe, and on unanticipated policy developments in the U.S. or Europe.
- Everything else is already priced in, including expected ECB QE and expected Fed normalization.
- This suggests that the best guess about future movements in this exchange rate are largely unpredictable, and that the best expectation of the future exchange rate is the current level.

Summary

Answers to the five questions

- The probability of a hard landing in China is no higher today than it was earlier this year.
- Financial stress today in the U.S. is not particularly high compared to the last five years.
- U.S. labor markets have largely normalized.
- Oil price stabilization likely implies headline inflation will return to 2 percent in the U.S.
- Global policy divergence has already been priced into foreign exchange valuations.



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