The Long Unwinding Road: Undoing the Aftermath of Crisis-Era Policy

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February 20, 2018

Progression of Topics

1. Update on Performance of Economy
2. Federal Reserve Crisis Policies
3. Unwinding
4. Future Outlook

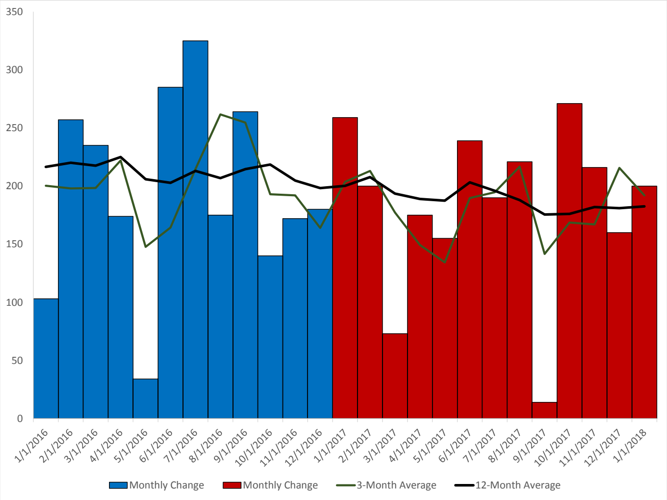
Since 2016

Thriving economy since 2016

- Adding 188k jobs per month
- Unemployment down to 4.1% from 4.9%
  - Well below the natural rate (NAIRU)
- GDP growth averaging 2.14% annually (2.47% in 2017)
- Stocks are up (e.g. DJIA up to 25,000 from 17,100)
  - Recent volatility due to labor market and GDP growth
- Inflation around 1.5%; below 2% target

Job Creation

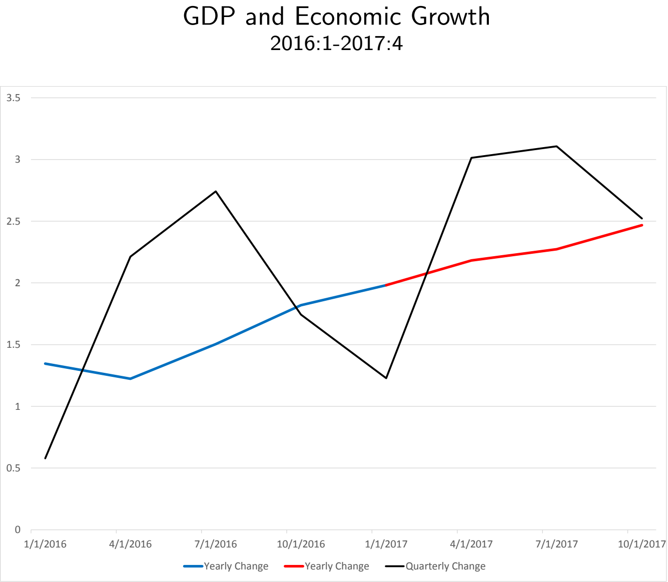
Change in Non-farm Payrolls (1000s)
2016:1-2018:1



Unemployment Rate

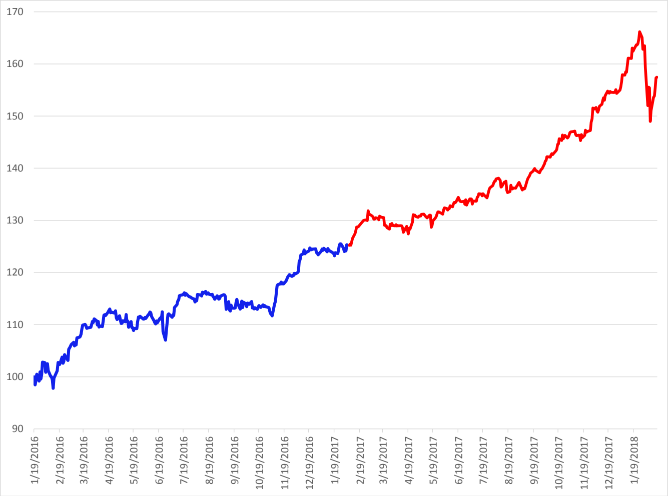
Unemployment Rate and Natural Rate of Unemployment
2015:1-2017:4

GDP

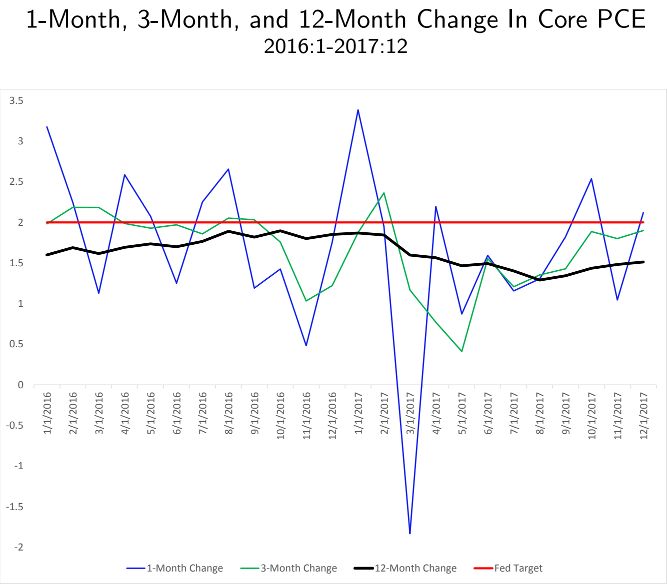

GDP and Economic Growth
2016:1-2017:4
3.5
3
2.5
2
1.5
1
0.5
0
1/1/2016
4/1/2016
7/1/2016
10/1/2016
1/1/2017
4/1/2017
7/1/2017
10/1/2017
Yearly Change
Yearly Change
Quarterly Change

Stock Indices

DJIA 2016:1-2018:2



Core PCE Inflation



Summary

- Economy is “fully recovered” from financial crisis and Great Recession
  - Unemployment well below natural rate
  - GDP steaming ahead
- Tax plan will add to growth in GDP, employment, (and wages?)
- Worry of inflationary pressures and higher-than-expected interest rates affected stocks

Crisis Policies and Tools

Interest Rate Tools - New

- Interest on excess reserves (IOER) - floor on short-term rates
- Overnight Reverse Repurchase Facility (ONRRP) - OMO for non-traditional institutions (MMFs)

Lending Tools - Wrapped up

- Commercial paper funding facility (CPFF)
- Term asset-backed securities loan facility (TALF)

Liquidity Tools - Balance Sheet

- QE1, QE2, QE3
- Operation Twist
- MBS Purchase Program

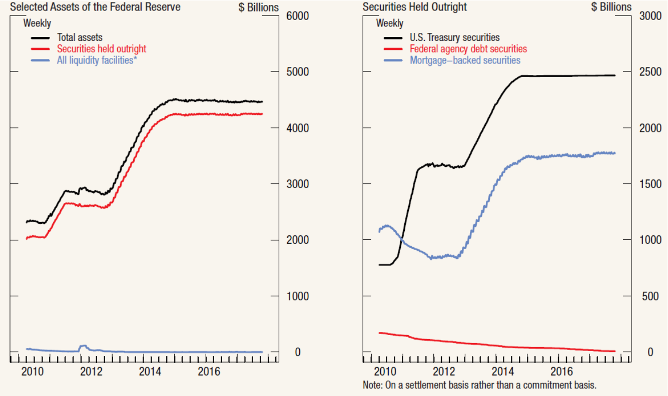
Unwinding

Fed spent ALL ammo fighting crisis

- Interest rates were zero for 7 years
  - Gradual normalization or rapid tightening?
- New tools and policies
  - Unwind or undo?
- Extremely large balance sheet
  - \$4.5T (since 2014) from <\$1T in 2008
  - Gradually undo or rapid selloff?

Federal Reserve Assets

2010:1-2017:11



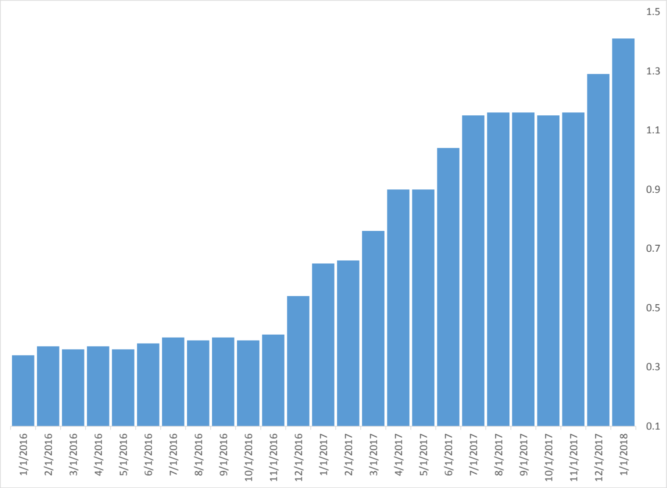
Interest Rates

- Overnight rate has risen from 0% in 2015 to 1.50% today
- January FOMC kept rates unchanged, but markets expect 3 more hikes in 2018
- Inflationary pressures from job market may increase more than the expected 75 BP

- IOER will keep up pace with FF rate – still acting as a floor
- Will stay in arsenal to be used down road

Effective Federal Funds Rate

2016:1-2018:1



Reverse Repo/ Tri-Party Repo Market

- Maintain active engagement in ONRRP facility to raise short-term rates for non-Fed institutions
- ONRRP absorbs supply in the repo market, and raise rates for MMF repo borrowers
- Fed can reign in overall money it created in crisis and help achieve target rates

Asset Balances

Initializing stoppage in security reinvestment

- Treasuries
  - Decline of $6B with 4 $6B increases every 3 months (up to $30B)

- Agency Debt and MBS
  - Decline of $4B with 4 $4B increases every 3 months (up to $20B)

Normalization

Interest Rates

- Interest rates will continue to gradually rise
- IOER rise as well, driving up other rates
- Expect 2.25% overnight rates by year-end

"The Committee expects that economic conditions will evolve in a manner that will warrant further 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. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data."

- Many anticipate rates up to 4%-5% within a few years
- Faster/higher if continual strong economic performance triggers inflationary pressures

Unwinding

Balance Sheet

- Policies implemented for crises have been over since 10/2014
- These programs have left Fed with large asset balance
- Gradually undo these programs by allowing securities to mature without rollover
  - Start slow and increase cap every 3 months for 1 year
  - Largest effect in Treasuries, but MBS also affected
- Gradually increase long-term rates as well

Conclusion

- U.S. is completely recovered from crisis
- Strong economic performance will include:
  - Rises in short-term rates
  - Further rises in long-term rates - yield curve effects and balance sheet dwindling
- Lower market value of existing securities
- Current purchase of assets at lower rates than future purchases
- Worries:
  - Wage growth and strong employment numbers suggest possible overheating
  - Faster rate hikes than expected
  - Increased stock volatility

Thank You

- Questions or Comments?

- Contact me:

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