An Economic Outlook

Shadow Open Market Committee
Fall 2019 Meeting

Princeton Club
New York, NY

September 27, 2019

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President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

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The views expressed today are my own and not necessarily those of the Federal Reserve System or the Federal Open Market Committee (FOMC).

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It's a pleasure to be here today.

One of the great joys of this job is being surrounded by some of the world's best economists and policy experts, whose ideas and insights are central to the Fed's work and mission. On occasions such as today, we sometimes take the opportunity to share new research by Fed staff or an idea that we've been debating.

Sometimes life makes those choices for us.

Given the turmoil in the money markets last week, this seems to be one of those times.

So with that in mind, I'll start with a quick outlook for the economy, then delve into what happened last week, and what it means. Spoiler alert: It does not affect the stance of monetary policy or have a meaningful impact on the economy.

I thought I'd get that out there nice and early.

As I venture into this discussion, I'll start with the requisite Fed disclaimer that you've all heard before — and that some of you have delivered yourselves — that the views I express are my own and do not necessarily reflect those of anyone else in the Federal Reserve System.

The Outlook

With that caveat firmly in place, the headline is that my outlook hasn't really changed.

The labor market continues to show remarkable strength, and we're creating jobs above the rate we need to keep pace with growth. I expect unemployment to stay below the 4 percent mark for the next couple of years, assuming economic conditions unfold as forecast.

Inflation has been persistently below target for some time, but it does appear to be on track to meet our preferred 2 percent goal — albeit slowly — and I think we'll get there in the next 18 to 24 months.

While concerns about growth have been amplified lately, the trajectory looks to be about on track with our recent forecasts. Consumers continue to be the engine powering growth, fueled by the strong labor market. I continue to see overall GDP growth for 2019 a little above 2 percent, returning to trend of about 2 percent next year.

That said, there are clear downside risks, mostly posed by trade and international developments and the uncertainty they breed. It is that uncertainty, more than anything, that is affecting business decisions. We hear it again and again from our contacts, it surfaces over and over in the Beige Book, and it's showing up in data on confidence and investment across multiple sources.

That leads me to a point I've made before. Fed watchers often note that many of us have themes or phrases we return to often. Two of my most frequent are: It's important to remember that growth is fundamentally the simple sum of growth in the labor force plus growth in productivity. And monetary policy is a relatively blunt tool with relatively limited scope. The Federal Reserve can pull the levers available to us to create a more hospitable environment for growth, but trend economic growth is driven by fiscal policy. Monetary policy can't mitigate risk or move the growth needle in a meaningful way.

Now that I've delivered my oratorical calling cards, the issue people care about most: rates. My own view is that we should hold firm, letting things settle and watching how events play out.

And with that, I'll to turn to the other topic on everyone's mind.

What Just Happened?

As a quick recap: Last week, there was unusual stress in money markets, due primarily to funds flowing to the Treasury to meet corporate tax payments and settle Treasury security purchases. There was a significant surge in repurchase — or “repo” — rates early in the week, which put upward pressure on the effective federal funds rate, and, in fact, pushed it above the top of the target range on Tuesday.

While interest-rate control and market functions are obviously important issues, I want to reiterate my opening note that they neither reflect — nor direct — the stance of monetary policy. Nor do they have implications for the wider economy.

It’s clear that last week’s episode was triggered by the outsized flows of private sector funds to the Treasury. But the dates for tax payments and bond settlements are not a surprise; they are fixtures of the fiscal calendar and well known to both policymakers and markets. Everyone was expecting large liquidity flows.

The impact, however, was clearly much larger than anyone anticipated, markets included.

The repo market took the brunt of the impact, as the Secured Overnight Financing Rate (SOFR) rose above 5 percent last Tuesday, with some trades executed at rates as high as 10 percent.

While this was certainly not an average day, it’s important to note that the repo market didn’t freeze. The volume of secured overnight finance remained steady, at the $1.2 trillion level it has maintained for the past several months.

The funding pressures in secured markets passed through to the federal funds market. The effective federal funds rate rose to the top of target range on Monday the 16th, and surpassed the top of the range by 5 basis points the next day.

That day, Tuesday, the New York Fed’s Open Market Trading Desk started repurchase operations to stem the pressures on money markets, and continued them for the duration of the week. Additionally, two technical adjustments were agreed upon at last week’s FOMC meeting: First, the interest paid on reserves was set 20 basis points below the top of the target range; and second, the overnight reverse repo rate was set 5 points below the bottom of the target range.

Those measures successfully relieved funding pressures, and the effective fed funds not only moved back within the target range, it came down to 10 basis points below the range's ceiling that Thursday and has remained there. Conditions started to normalize in repo markets as well, with repo rates drifting lower on Thursday and Friday, and starting this week around 1.85 percent. In fact, there was a significant drop in the fraction of volume in the federal funds market that traded at rates above the target range. For instance, less than 1 percent of the total fed funds volume was priced outside the target range.

On Friday, the Desk announced that it would initiate a series of repo operations — including several term operations — to help keep the fed funds rate within the target range. Those operations will continue until October 10. We have seen strong demand for repo operations this week, possibly indicating that funding pressures may return on quarter-end, and the Desk stepped up the operation limits yesterday. As Chair Powell noted at the post-meeting press conference, we will continue to monitor market developments and adjust operations as necessary to ensure that rates in the federal funds market stay within the target range.

The obvious question that arises — and indeed has been asked — is whether the current level of reserves is appropriate. And whether the Fed might need to expand its toolkit to better manage interest rates.

I don't think we can adequately answer those questions without first taking a step back and seeing them in their wider context.

As you know, earlier this year, the FOMC decided that we would continue to conduct monetary policy in a regime of "ample reserves," in which control over the federal funds rate is exercised primarily through the setting of administered rates, and the supply of reserves does not need to be actively managed.

Shortly after that, we announced our plan to cease asset redemptions and hold the balance sheet to roughly its post-redemption size. As currency and other non-reserve liabilities grow, aggregate reserves see a natural, gradual decline. Our end game was for reserves to reach a level "consistent with efficient and effective implementation of monetary policy."

There were two primary objectives to this approach. First, to reduce uncertainty about asset purchases by announcing our plans well in advance. Second, to approach the necessary level of reserves, which is itself suffused with uncertainty, with an abundance of caution.

We only have estimates of the demand for reserves, though we've conducted a great deal of research around the Federal Reserve System, including continued conversation with market participants. In fact, staff at the Philadelphia and New York Feds were among the first to identify that the need for reserves could be much larger than anticipated. To be on the safe side, it made sense to move slowly, buying time to carefully observe market developments and better assess their implications. That is, we gave ourselves time for the inevitable "unknown unknowns" of life — like the one that occurred last week, just to pick an entirely random example. And in fact, while they may appear jarring in the moment, temporary episodes like this offer a host of information and insight.

It is very possible that reserves are near, or approaching, their appropriate level — that it is, as the Philadelphia and New York Feds' research noted it might be — on the higher end of our estimates. If that is the case, we may need to resume the organic growth of the balance sheet earlier than anticipated.

We will continue to monitor and assess money market conditions, and act as necessary to ensure interest rate control. I think a central question is why the liquidity did not flow smoothly to where it was needed most.

I'll once again save you any suspense: I have more questions than answers. I think it's important to avoid jumping to conclusions, and I certainly wouldn't write any prescriptions — policy or otherwise — before we know what ailed the markets.

In the oft-used analogy of the money markets as plumbing, we should ask whether some pipes might be rusty. Or clogged. Or if more might be needed.

It is also worth asking if regulation might be contributing to any erosion or blockage that might exist.

The second question is whether the Fed ought to expand our toolkit. As many of you will have noted from the June FOMC minutes, there was a discussion about the possibility of a standing-repo facility. In theory, this could provide a backstop against unusual spikes in the federal funds and other money market rates. These discussions are in their infancy, and there is more work to be done, particularly in considering how such a facility would be designed, what its objectives would be, and what its net benefits would be relative to alternative approaches.

Conclusion

All in all, I see three key takeaways from this interlude. First, in the face of unexpected turmoil, the Fed took swift and appropriate action, and it appears to be having the desired effect. Second, the element of surprise suggests some deeper issues may be at play. And third, that the Fed is committed to do what it takes to maintain interest rate control, and we will continue to keep a watchful eye.