MAIDEN LANE DIVISION: Preliminary Round Case Study

I. Your Role

You are a senior economist at the Federal Reserve Bank of New York, and are tasked to prepare a monetary policy recommendation for the upcoming Federal Open Market Committee (FOMC) meeting in a few weeks. Use the information on current economic conditions described below and your understanding of various economic relationships to inform your analysis.

II. Hypothetical Scenario

Economic growth as measured by real GDP remained little changed at 1.6 percent in Q4-2016. While growth rates have exceeded potential rates, growth was relatively slower in 2016 than in 2015. However, nominal GDP has risen lightly at was at 3.2 percent in Q4-2016, relative to 3.0 percent a year ago. Table 1 presents GDP growth rate data over the last two years, while Appendix Figure 1 provides the historical series. The observed increase in real GDP reflects increases in the following underlying components: real consumption and government spending. Detailed underlying contributions to the overall growth rate are shown in Table 2 and in Figure 1.

The labor market has not changed much over the last four quarters. However, the unemployment rate remains at its lowest level since the recent recession at 4.9 percent. The nonfarm payroll employment rose by 420,000 jobs in the last quarter of 2016 (down from 721,000 jobs a year ago). Average hourly earnings for all employees have increased, albeit very slightly. Figure 3 shows the evolution of unemployment rates since recession, while Table 3 shows several statistics from the labor market over the last two years.

Inflation continues to remain slightly below the 2 percent target inflation rate over the last few years. Headline PCE inflation was at 2.4 percent in the most recent quarter, while core PCE inflation stood at 1.5 percent, reflecting the recent recovery in oil prices since 2015. Headline and core measures of inflation over the last two years are provided in Table 4, while select historical series are presented in Appendix Figure 2. Oil prices are shown in Figure 5.

Given these developments, inflation expectations for both headline PCE and CPI measures have ticked up slightly, as shown in Table 5. However, the increase in inflation expectations has been pushed back a few quarters for measures of core inflation.

Consumer confidence has remained at slightly lower levels compared to 2015, reflecting slow growth in the labor market and wages, and may reflect concern for potential further increases in oil prices. The consumer confidence index is presented in Figure 4.

The Fed recently raised the target federal funds rate in the second half of 2016. The effective federal funds rate in the market is shown in Figure 6. Given the recent economic indicators described above, what would you recommend to the FOMC? Explain.

III. Policy Analysis

When conducting your analysis, it is always good to keep the overarching goal of monetary policy in mind. This goal is often referred to as the dual mandate, or specifically, the goals of maximum employment and price stability. There are often tensions between these two goals and your role as an economist is to understand how to achieve one without compromising the other.

The hypothetical scenario above described several economic indicators from various sectors of the US economy. A rule of thumb when trying to understand the data (or any type of data) is to ask yourself the following questions:

1. What is the data trying to say?
2. How will the data inform me about the dual mandate of price stability and maximum employment?
3. How will my policy recommendation affect these two goals?

Even the most seasoned central bankers have to keep these basic questions in mind, and it is a good idea to develop this habit. This is especially useful since you will certainly encounter numerous economic indicators and data series coming from various sectors of the US economy, and sometimes even the global economy.

To further guide you with your analysis, use the focus questions below and the accompanying Primer on Monetary Policy.

1. What is the overall state of the economy? Are there specific aspects of the economy contributing to the level of growth?
2. What is the condition of the labor market? Why do workers enter and exit the labor market?
3. What is the current inflation rate? What factors are affecting the price level?
4. How might wages affect inflation?
5. Why might the Fed be concerned about the impact of oil prices on the economy? What, if any, are the channels through which oil prices affect core inflation? In other words, should the Fed track both headline and core inflation?
6. What is the current household outlook observed in the data and what is the role of consumer confidence in the macroeconomy?

7. Given the Fed’s dual mandate and your analysis of the economy, what policies would you recommend that the Fed implement?
8. How would the Fed implement its monetary policy? What conventional tools does the central bank have at its disposal, and which tools would you use for your policy?
9. What is the monetary transmission mechanism of your policy? Specifically, what are the goals of your policy given the scenario above, and how does the policy achieve these goals?