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. Scenario

Economic growth as measured by the quarterly growth rate of real GDP remained at 1.6 percent in Q3-2017. Nominal GDP growth was little changed at 1.9 percent in Q3-2017, relative to 2.0 percent growth a year ago. Economic growth rates slowed down in 2017 relative to growth rates in the prior two years. Table 1 presents GDP growth rate data over the last two years, while Appendix Figure A1 provides the historical series. The real GDP growth rate reflects a steady decline in underlying real consumption. The contribution of fixed investment to growth has also declined in the most recent quarter. Detailed underlying contributions to the overall growth rate are shown in Table 2 and in Figure 1.

There was an uptick in the unemployment rate in Q3-2017, rising to 4.9 percent from 4.6 percent in the last quarter. This is the first increase in unemployment since its steady decline in 2015. The nonfarm payroll employment rose by 420,000 jobs in the same quarter 2017, compared to 490,000 jobs a year ago. Average hourly earnings have been relatively stagnant in the last year. Figure 2 shows the evolution of unemployment rates since the 2007 – 2009 recession, while Table 3 shows several statistics from the labor market over the last few years.

Inflation continues to remain below the 2 percent target core PCE inflation rate over the last few years. Headline PCE inflation was at 1.5 percent in the most recent quarter. Meanwhile, core PCE inflation stood at 1.4 percent. Headline and core measures of inflation are provided in Table 4, while select historical series are presented in Appendix Figure A2.

Given these developments, inflation rates based on both PCE and CPI are broadly expected to remain the same throughout 2018 (Table 5).

Consumer confidence has declined since Q1-2017, yet remains approximately equal to or higher than measures of consumer sentiment a few years prior in 2013. The consumer confidence index is presented in Figure 4.

The Fed has been slowly raising the target federal funds rate since 2016. The effective federal funds rate in the market is shown in Figure 5. 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 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 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?
3. What is the current inflation rate? What factors are affecting the price level?
4. How might wages affect inflation?
5. 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, and how does the policy achieve these goals?