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HAWK Talon

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The Federal Reserve and The Newest Normal Monetary Policy.

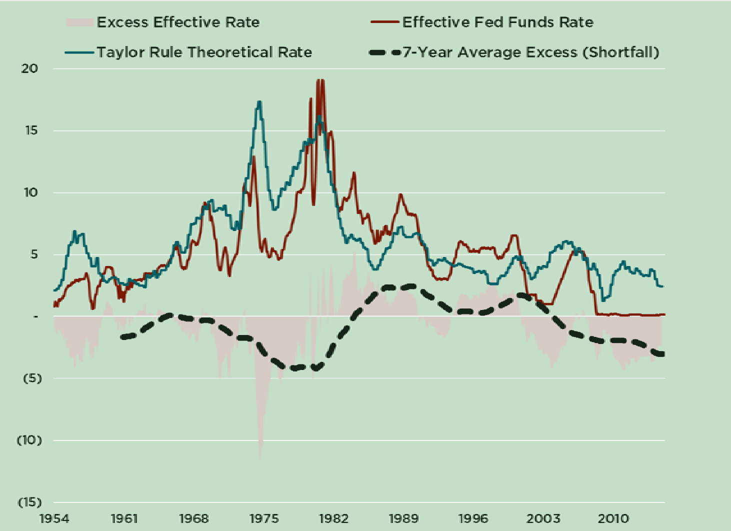
The US Federal Reserve tasks its Federal Open Markets Committee (FOMC) to establish monetary policy for the US. The FOMC wrapped a highly watched meeting September 17 with a statement that the Federal Funds rate target, at which member banks lend funds overnight, would remain 0—0.25% and that the Fed would continue reinvesting maturities thereby holding the balance of its assets at over $4.5 trillion.

The Fed is supposed to seek price stability (the Fed targets 2% inflation) and full employment (a moving target). The September 17 statement concluded as follows, the FOMC "anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

The Fed itself had hinted that it would raise rates through what it called "The New Normal Monetary Policy." By maintaining near-zero rates the FOMC seems to have lost a reasonable view as to what is "normal."

Speaking of normal. Fed Chair, Janet Yellen, delivered a speech titled, "The New Normal Monetary Policy," in San Francisco during March. Ms. Yellen discussed why she and her colleagues "believe the return of the federal funds rate to a more normal level is likely to be gradual." Yellen acknowledged "special risks" for Fed consideration while reinstituting normal policy. Since then, markets have adjusted to likely Fed rate hikes.

Redefining normal. Seven full years after Lehman Brothers failed, the new normal looks odd. The Fed holds over $4.5 trillion—five times its assets when Lehman collapsed. The Fed funds rate remains near zero after 82 months and has been well below where rates should be under the Taylor Rule prescription.



Fed Funds and Taylor Rule, 1954-2015. Source Federal Reserve.

The Taylor Rule is an interest rate policy guideline developed by a Stanford economist. Theoretically, it guides what nominal interest rate would achieve the inflation target consistent with full employment.

Recessions and/or rapid rate increases followed when rates have held too low for too long. Delaying normal, the Fed increases risks that more painful adjustments will be needed to return to normal.

Hawk100 suspects that the Fed lacks the political capital needed to reinstitute normal. Near zero rates are likely to remain perhaps as late as 2017. Then, rapidly rising rates may prove necessarily the newest normal monetary policy.

By Richard Clemens, CFA CPA, *President*

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