The impact of Fed policy on the business environment

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It’s not your father’s Fed

The Fed added policy options during the financial crisis

<table>
<thead>
<tr>
<th>Before</th>
<th>After</th>
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<tbody>
<tr>
<td>Open market operations</td>
<td>Also</td>
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<tr>
<td>Discount window</td>
<td>• Interest rate on reserves</td>
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<tr>
<td>Reserve requirements</td>
<td>• Alternative lending methods</td>
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<td></td>
<td>• Term deposit facility</td>
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<td></td>
<td>• Overnight repurchase agreements</td>
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<td></td>
<td>• Others which have expired</td>
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<tr>
<td></td>
<td>• QE tools (now officially expired)</td>
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<td></td>
<td>• Maturity extension program</td>
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<td></td>
<td>• Purchase of ABS securities</td>
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Wow, that’s a lot of stuff the Fed has bought. What does it mean?

The Fed’s new clothes.

The Fed has to change how it conducts policy.

**Problem**
- Open market operations require selling T-bills. The Fed no longer owns T-bills.
- Private holdings of T-bills are much larger than before 2008. So larger operations would be required to affect the market.

**Solution**
- Use the interest rate on reserves to set an upper limit on the Fed funds rate. (No reason for banks to lend Fed funds if they can earn a higher rate by keeping deposits at the Fed.)
- Use repurchase agreements to put a floor on the Fed funds rate.

Did it work?
Shrinking the balance sheet: What will happen to the excess reserves?

The Fed will try to “normalize”.

The forecast
Growth is in the forecast, but pay attention to the alternatives.

Four scenarios for GDP growth

<table>
<thead>
<tr>
<th>Percent change</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coordinated global recovery</td>
<td>4</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>-1</td>
<td>-2</td>
<td>-3</td>
<td>-4</td>
</tr>
<tr>
<td>Baseline</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>Recession</td>
<td>-1</td>
<td>-2</td>
<td>-3</td>
<td>-4</td>
<td>-5</td>
<td>-6</td>
<td>-7</td>
<td>-8</td>
<td>-9</td>
</tr>
<tr>
<td>Continued slow growth</td>
<td>-2</td>
<td>-3</td>
<td>-4</td>
<td>-5</td>
<td>-6</td>
<td>-7</td>
<td>-8</td>
<td>-9</td>
<td>-10</td>
</tr>
</tbody>
</table>

Source: Deloitte/Oxford Economics

Four alternatives

1. **The baseline**: growth will pick up to the 3.5% range. 55%

2. **Continued slow growth**: More of the frustration we’ve been experiencing in the past few years. 25%

3. **Recession**: Chance of a financial shock in Europe or China. How do we know banks aren’t exposed to risk? How do they know? 5%

4. **Coordinated global boom**: More likely than you might think. Europe and China are on their way to fixing their problems. So is the U.S. 15%

Short run—demand
Households are in better shape than they’ve been in a long time

The household debt burden is at its lowest point ever.

Employment growth continues to be strong.

Housing still has a long way to go to recover.

Lots of unanswered questions here.

- How much housing do we need? And what type?
- How important are credit restrictions—and how should policymakers react?
- Why would anybody invest in a 30-year mortgage? Do we need a new housing finance paradigm?

Equipment and intellectual property investment above pre-recession levels

Structures are a special case—probably related to weak residential construction.
Government has been an important reason for the slow recovery

But we get a bump from the budget agreement (and the highway bill).

US competitiveness presents a short-term problem, but a long-term opportunity.

But... weakness in China and especially in Europe is pushing up the dollar.

Long-term interest rates: nowhere to go but up?

It would take a recession to let long term rates fall. And there's not much room below.
Medium term: inflation (and financial markets)

Don't expect much inflation
The big bugaboo of the recovery is not a big source of risk.

CPI growth in four scenarios
percent

- Continued slow growth
- Recession
- Coordinated global recovery
- Baseline

Source: Deloitte/Oxford Economics

Labor costs are still flat.

Why the big jump in employer cost? The difference between this measure and the others seems to be bonuses...possibly in the financial sector.

Source: BLS/Haver Analytics
There are limits to profit growth.

Profits should be set to grow at a satisfactory rate for the next few years. But don’t be surprised if labor begins to regain its share of national income in a healthy economy.

The long run

Long run growth is a matter of population and productivity.
The global economy: Can’t anybody here play this game?

There are two other players that matter

- Europe
- China

To grow or not to grow? Europe is experiencing a Hamlet recovery.
Something's casting a shadow over Europe.

The ECB is trying…and maybe even succeeding.

Are China's problems finally catching up with the countries' economy?
As the real estate bubble subsided, the stock market bubble took its place.

Growth may be slowing.

More detailed data doesn’t support that latest impressive figure. Chinese authorities are caught between keeping growth up and preventing more overinvestment.

China’s Long-Term Demographic Problem

China’s aging population will very soon begin to pinch labor markets there. Within ten years, the prospect of supporting large numbers of retirees will create a substantial challenge for the Chinese economy.
The Deloitte economics team welcomes your questions!