The Federal Reserve, Monetary Policy and the Employment Report

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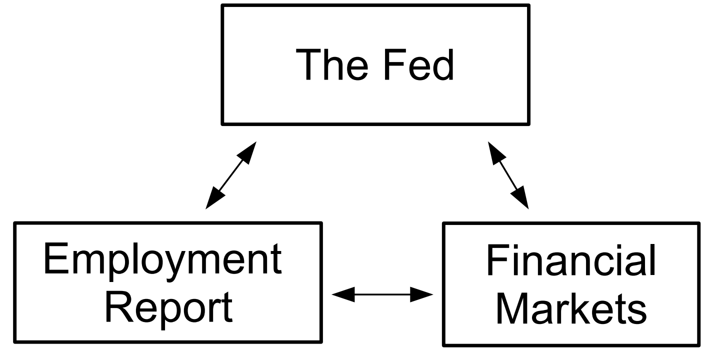
The analysis set forth does not necessarily reflect the views of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

Topics of Today's Talk

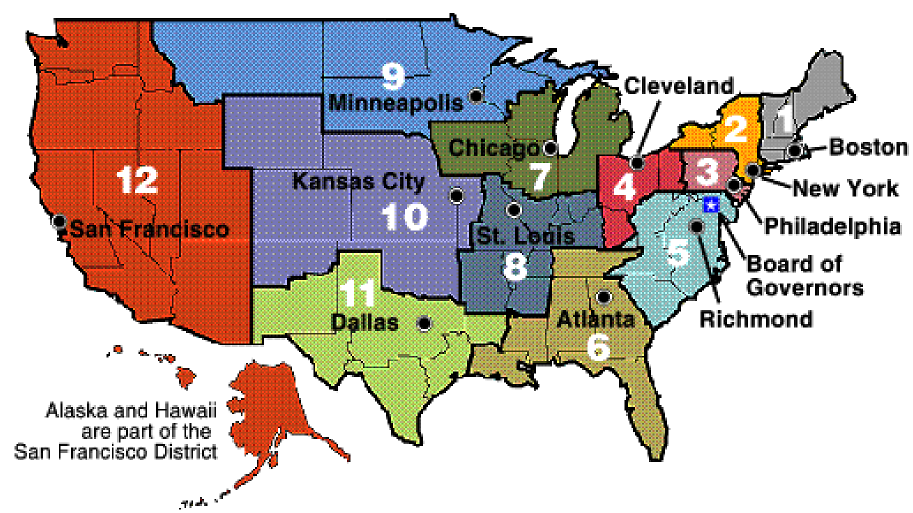


The Federal Reserve

The Federal Reserve (the Fed): the central bank of the United States

central bank: institution designed to oversee the banking system and regulate the quantity of money in the economy

The Board of Governors & 12 Federal Reserve Banks



Responsibilities of Federal Reserve

1. Regulates banks & ensure health of banking system
   - clears checks
2. controls short-term interest rate and money supply (i.e. monetary policy)
   - through open market operations
3. Prevents bank runs
   - a bank run is a simultaneous attempt by depositors to withdraw their money from a bank because they think it will fail
   - Fed's willingness to supply money to banks can help prevent bank runs (and non-bank runs as well)

open-market operation is purchase and sale of U.S. government bonds by the Fed

Open market operations & the FOMC

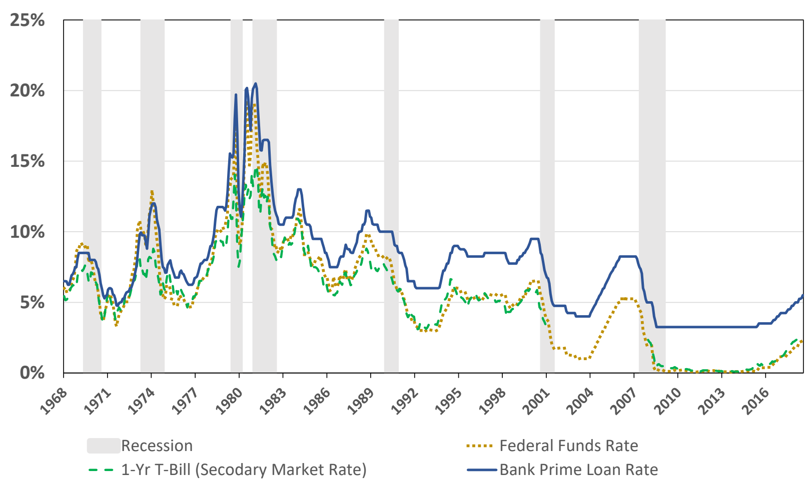
Open market operations decided within the Fed, by the Federal Open Market Committee (FOMC)

- Consists of Fed governors & 5 of the Federal Reserve Bank presidents
- Federal Reserve Chair is also head of FOMC

About eight scheduled meetings per year

The FOMC uses control of the money supply to target the federal funds rate, which is the rate at which banks make loans to each other

Controlling the federal funds rate



Federal funds rate influences rates that consumers and businesses can get.

Monetary policy objectives of the Federal Reserve

Section 2A of the Federal Reserve Act:
"... maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of **maximum employment**, **stable prices**, and **moderate long-term interest rates**."

In simpler terms, the goals are:

1. low unemployment rate (also high real GDP growth)
2. stable prices (or at least low inflation)

Labor market

Households sell hours (which includes skill and effort)

In exchange, businesses buy hours of work in exchange for wage payments

- also called labor income (for households)
- wage rate is number of dollars per hour

A Primary Concern of the Fed

Suppose unemployment rate becomes so low that firms cannot hire workers at the going wage

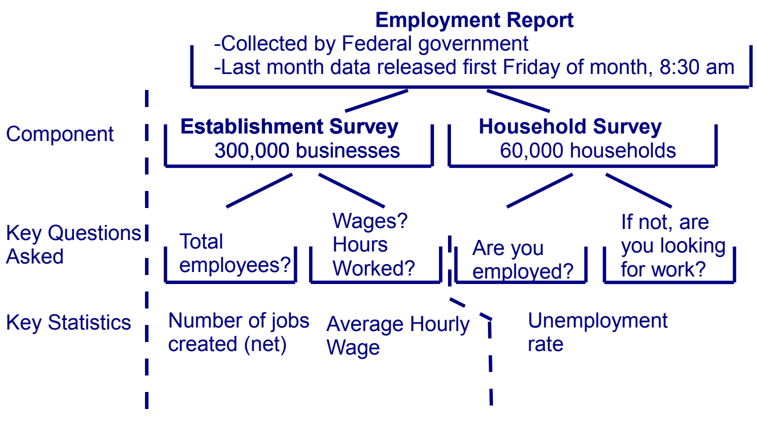
Firms must pay higher wages to attract employees in a "tight" labor market

Firms pass on higher cost via higher prices to consumers

Inflation: an increase in the overall level of prices in the economy

Inflation's negative effects justify one part of the Fed's "dual mandate"

U.S. Employment Report



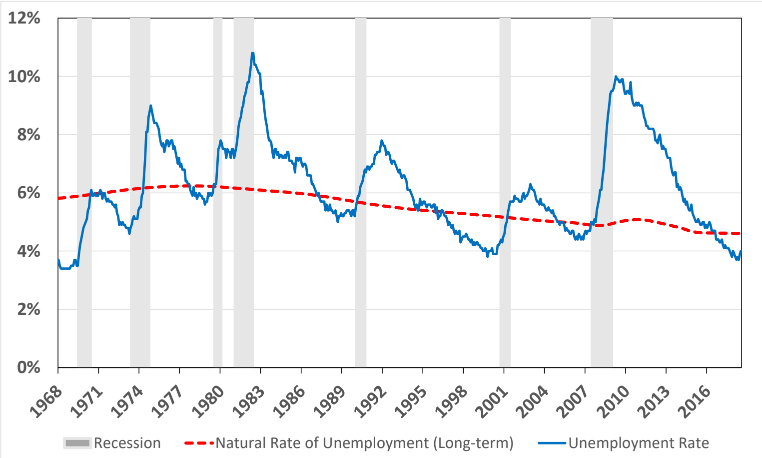
Measuring unemployment

- Each adult (based on past month) is one of these:
  1. **employed:** worked during past month (includes temporarily missing work)
  2. **unemployed:** were not employed and had looked for work
  3. **not in labor force:** none of above, such as a full-time student, homemaker

Sum of these three groups is the adult population
The employed and unemployed make up the labor force

$$\textbf{Unemployment rate} = \frac{\text{Numb of unemployed}}{\text{Numb of unemployed} + \text{Numb of employed}} \times 100$$

U.S. unemployment rate, 1968-2019

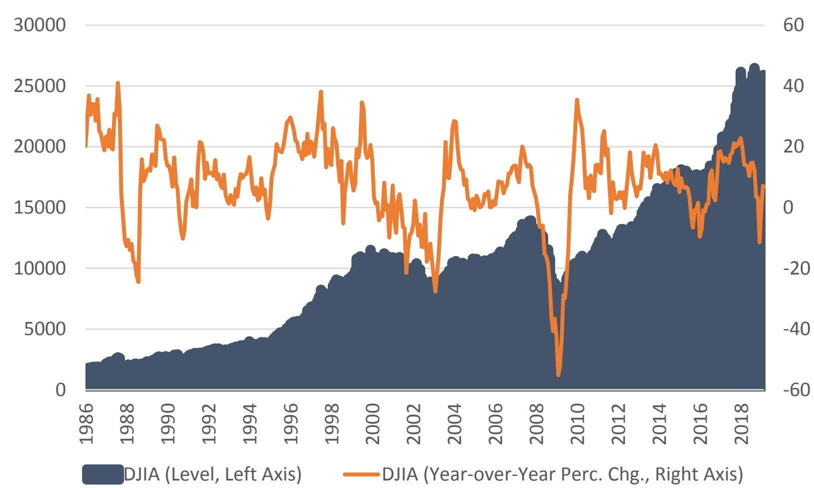


natural rate of unemployment: normal rate of unemployment around which the actual unemployment rate fluctuates

Watching financial news: non-farm payroll

- **(change in the) non-farm payroll:** total jobs created minus jobs lost, from the employment report, usually reported over a one-month period
  - more important to financial markets than unemployment rate
- vocabulary
  - **Efficient markets hypothesis**: theory that an asset's price reflects all publicly available information about the asset's value; example: in late Jan. 2010, Toyota lost 10% of its value ($12 bil) in one day on announcement of 2+ million car recall
  - **Dow Jones Industrial Average** (DJIA, DOW): measures the stock market value of 30 major U.S. companies

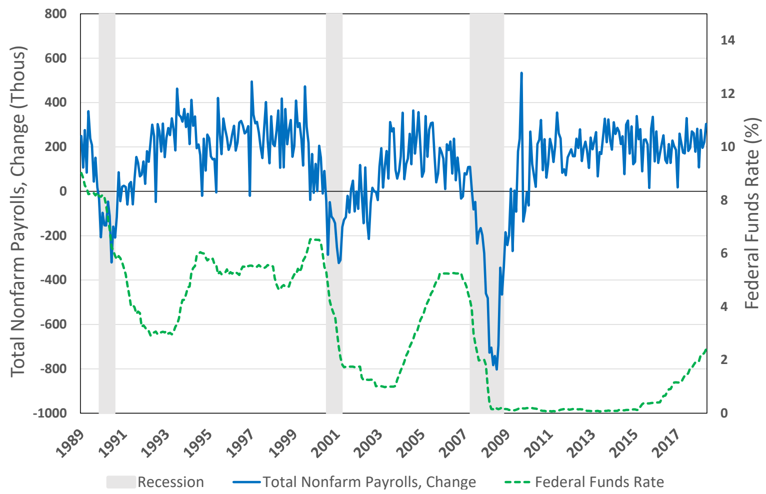
Dow Jones Industrial Average (DJIA)



January 2012 Employment Report

- Big change in asset price because actual report was different than expected
  - unemployment rate: expected = 8.5%; actual = 8.3%
  - change in non-farm payroll employment (number of workers): expected = +125,000; actual = +243,000
  - DJIA increased 0.8% in the first few minutes following the announcement (from 12672 to 12770)
  - This represents hundreds of billions dollars increase in wealth to owners of the companies included in DJIA
- Illustrates:
  - efficient market hypothesis
  - interrelationship between markets–labor market influences aka financial markets

Federal funds rate and change in the non-farm payroll



Two Sides to a Strong Jobs Report: Impact on Financial Markets

POSITIVE

Strong Jobs Growth
↓
More Income & Spending
↓
More Output & Firms Profits
↓
Higher Stock Prices

NEGATIVE

Strong Jobs Growth
↓
Greater Wage Pressure
↓
May Signal Future Inflation
↓
Fed Raises Interest Rate
↓
Reduces Borrowing & Spending
↓
Lower Stock Prices

Jobs Report Validates Fed on Both Patience and Economic Strength

By Sho Chandra
February 1, 2019, 7:30 AM CST
Updated on February 1, 2019, 10:40 AM CST

Hiring jumped by the most in almost a year, topping all forecasts in a Bloomberg survey of economists, albeit after a downward revision to the prior month, a Labor Department report showed Friday. While pay increases cooled from December, annual gains firmed up in recent months without signaling major inflation pressures that would worry Fed officials. "The trend looks very favorable in terms of momentum of job growth," said

JPMorgan Chase & Co. chief U.S. economist Michael Feroli. "Right now we dont have an inflation problem," he said, though "if we keep getting these strong job numbers eventually that looks like a possibility."

Source: Bloomberg.