Economic Review

with Nicholas S. Perna, Ph.D., Webster Bank Economic Advisor

The Economy: "At Long Last ..." I don't know whether Janet Yellen is a Frank Sinatra fan. However, when the Federal Reserve announced its big decision in December, my head was still full of the tunes that were being played a few days earlier as we celebrated what would have been Ol' Blue Eyes' 100th birthday. Hence, the Sinatra song titles below.

When the Fed finally said it was raising interest rates, I immediately thought of that great Sinatra song "At Long Last Love," written by Cole Porter, who studied at Yale and was a member of the Whiffenpoofs, the famous A Cappella men's singing group. Financial markets had been waiting — sometimes impatiently — for the Fed to act.

On December 16, the Fed hiked short-term rates a quarter point to a range of 0.25 to 0.5. Interestingly, this occurred on the seventh anniversary of when rates were cut to essentially zero in 2008 to combat the Great Recession.

"It Was a Very (Fairly) Good Year" helps explain why the central bank decided to move now. The U.S. economy is growing and job markets are improving. In fact, at 5 percent, the unemployment rate is close to what the Fed considers to be "full employment." The labor force is expanding again as more people look for work and more people find it. Some important labor market indicators are now close to pre-recession levels.

And, while inflation is running below the Fed's 2 percent target, it is likely to rise as the economy continues to expand, as well as when oil prices stop falling and the dollar exchange rate starts declining. (A lower dollar makes imports more expensive). Since it takes time for monetary policy changes to affect the economy, the Fed believes it should act now to keep inflation from becoming a problem in a few years. If they waited until inflation was accelerating, the job would be more difficult. Think of it this way - if you are speeding and can see the state trooper with his radar gun, then you're already in trouble. You should have put on the brakes earlier.

"Let's Take It Nice and Easy" could describe how policy will unfold over the next several years. The Fed's own forecasts — shown in the table — reflect the consensus of the members of the Federal Open Market Committee (FOMC) about the economy and interest rate policy. In a nutshell, the projections show the fed funds rate (more on this below) rising a percentage point in each of the next three years. As long as inflation and unemployment behave, then the Fed is finished raising rates. I'm now reminded of a great Peggy Lee song, *"Is That All There Is?"*

FOMC ECONOMIC OUTLOOK DECEMBER 2016

	2015	2016	2017	2018	Longer Term
Real GDP % ch	2.1	2.4	2.2	2.0	2.0
Inflation % ch	0.4	1.6	1.9	2.0	2.0
Unemployment %	5.0	4.7	4.7	4.7	4.9
Fed funds %	0.4	1.4	2.4	3.3	3.5
Nick's guesses					
10-yr Treasury	2.3	3.3	4.1	4.9	5.0

The Fed also published its longer-term forecast of what might be called the "equilibrium fed funds." That level is consistent with the economic environment when the Fed has achieved its inflation and unemployment objectives and the real Gross National Product is growing at its trend rate of 2 percent. Longer-term fed funds is in the vicinity of 3.5 percent — about a point and a half above the inflation rate.

Yellen and colleagues are silent on long-term interest rates. While they directly control short-term interest costs, they really can only influence long-term yields. The spread between fed funds and the important 10-year Treasury note is quite variable, but tends to narrow when the Fed is tightening and widen when it is easing. My guess is that in the longer run equilibrium, the spread would be about one percentage point or 100 basis points (bp). This would put the 10 year yield at 4 percent in 2017 and eventually at 5 percent.

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"That's Life" So what does this mean for households and businesses? The standard bank markup of the prime rate over fed funds is about 300 – 325 bp. Hence, two years from now, prime will be close to 5½ percent. The interest paid on loan balances linked to the prime, mainly credit cards and home equity lines of credit, will rise in lockstep.

Fixed rate mortgages will mirror the movement in Treasury securities and rise a bit less than short rates as the yield curve flattens in a normal cyclical pattern. The cost of a 30-year fixed rate conventional mortgage usually runs about 150 bp above the 10-year Treasury. Hence, these mortgages will be close to 5.5 percent two years from now — up from less than 4 percent recently.

As for business borrowings, loans linked to 3-month Libor will closely follow the path of fed funds. Real estate loans, which are often priced as so many percentage points over the Treasury yield curve, will show increases somewhere between the fed funds and the 10-year note – depending on their maturity.

"I Did It My Way" So far I have been discussing the FOMC decision in terms of fed funds — which is what banks charge each other for overnight loans. In the "old days," before Quantitative Easing (QE), the Fed would have sold Treasury securities in order to "drain reserves" from the banking system through *open market operations*. With fewer reserves available for interbank lending, the fed funds rates would rise to clear the market. Most other short-term rates would behave similarly.

Since QE began, however, the banking system has been awash in reserves, forcing the Fed to turn to different procedures to raise short-term borrowing costs. Thus, in December, the FOMC raised the rate it pays on "excess reserves" from 25 bp to 50 bp. This, in effect, raises the cost of making loans by an equivalent amount. Excess reserves are simply funds held by banks above the amounts required to support their deposits.

The Fed is also using something called "reverse repurchase agreements." "Reverse repos" have been around for a while. They will now be used as a major means for draining funds from the banking system. Basically, the Fed temporarily (overnight) sells some securities and agrees to buy them back. When financial institutions engage in these repos, the pool of excess reserves shrinks.

These unusual measures will have to be used for a while. Janet Yellen said that the Fed would not be reducing the size of its balance sheet, which has been bloated by QE, until short-term rates are normalized. And that won't even start for several years.

Let's just hope there is no *"Stormy Weather"* to upset these plans.

The Region: Affluence. F. Scott Fitzgerald supposedly said to Ernest Hemingway, "The rich are different from you and me." Hemingway allegedly replied, "Yes, they have more money." Measuring just how much more can get complicated.

INCOME BY STATES: 2014

	PER CAPITA MEAN		PER HOUSEHOLD MEDIAN	
	$	RANK	$	RANK
CONNECTICUT	62,467	1	65,753	4
MASSACHUSETTS	59,182	2	64,859	5
NEW JERSEY	65,807	3	67,458	3
NEW YORK	58,231	4	55,246	16
PENNSYLVANIA	47,727	17	50,228	23
RHODE ISLAND	48,838	18	53,636	17
UNITED STATES	46,129	-	50,502	

The first two columns show that Connecticut is still in first place in the annual *per capita income* derby. The last two give a different measure, *median household income*. Connecticut and Massachusetts drop a couple of notches while New York and Pennsylvania fall more in the rankings.

The two gauges differ in a number of ways. E.g., household includes food stamps while personal income doesn't. Per capita simply divides total state personal income by the total population. In contrast, household adds up the income of all members of the household — usually about 2.5 people.

The biggest difference is the use of the mean vs. the median. The mean is simply the familiar arithmetic average. The median is the midpoint where half the households are above and half below that level.

Suppose there are 10 guys in a bar, who each earn $50,000 annually. The mean and median income is $50,000. In walks Bill Gates, who is having a bad year, and only earns $100,000,000. Immediately, the mean income soars to $91,363,364, while the median stays at $50,000.

The concentration of very wealthy people at the top of the income distribution helps explain why most state rankings shown in the table for median measures are lower than for per capita incomes. Those billionaires in Fairfield Country raise the mean a lot for Connecticut but not the median.

Now I'm humming *"Pennies From Heaven."*

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