

***The Outlook, Monetary Policy,
and Interest Rate Risk***

FDIC Panel on IRR
January 29, 2010

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Bank Regulators and Interest Rate Risk

Federal Reserve Board Press Release
January 7, 2010

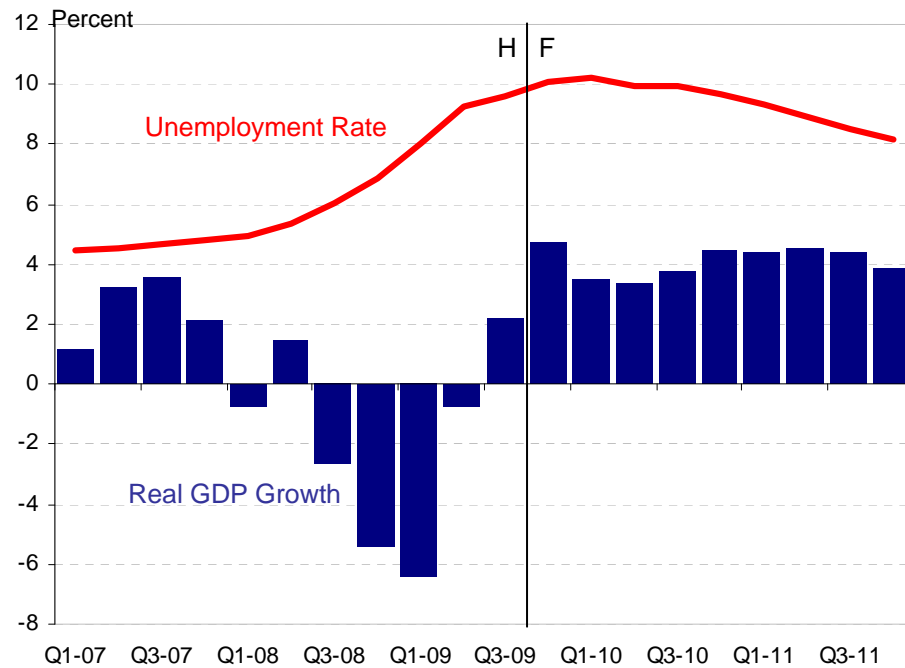
The Federal Reserve Thursday released an advisory reminding depository institutions of supervisory expectations for sound practices in managing interest rate risk. This advisory, adopted along with other financial regulators, reiterates the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls related interest rate risk exposures of depository institutions. It also clarifies elements of existing guidance and describes interest rate risk-management technique used by effective risk managers.

Sources of Interest Rate Risk

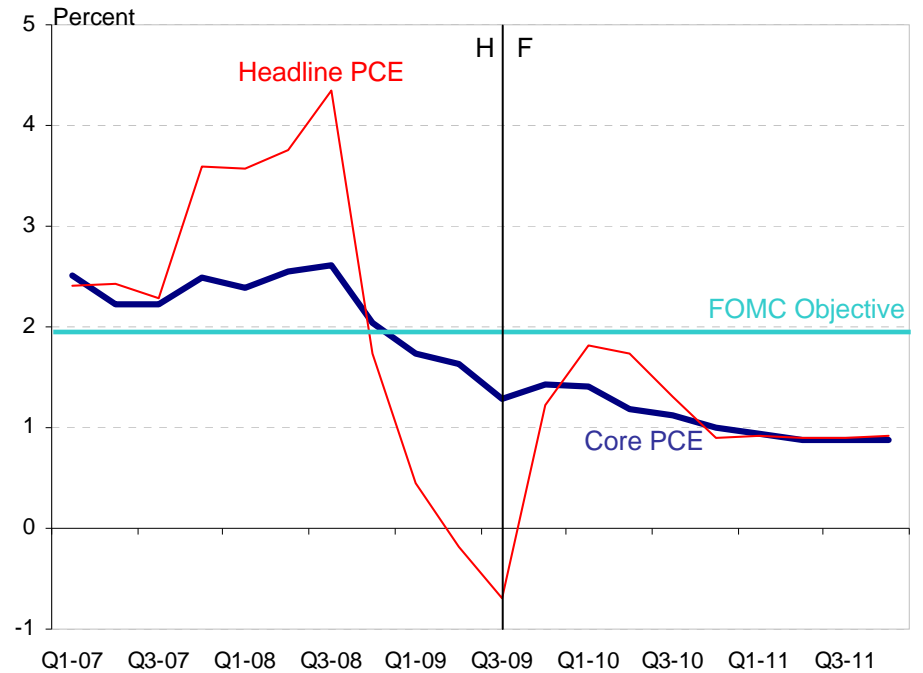
- Why the Fed Focus on Interest Rate Risk?
- The Outlook and Interest Rates
- Monetary Policy and Interest Rates
- Other sources of interest rate risk
- Forecast for Interest Rates

The Outlook for Monetary Policy

GDP Growth and Unemployment Forecast



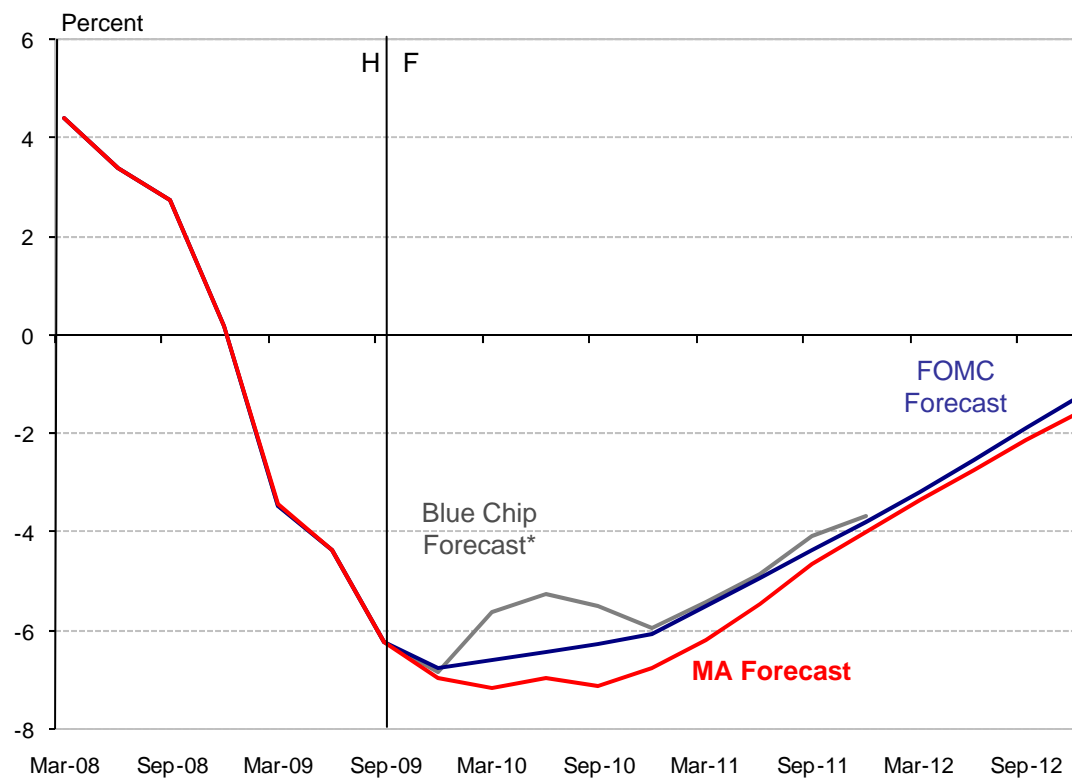
Inflation Forecast



Macroeconomic Advisers forecast prepared December 23, 2009.

When? Prescriptions from Taylor-like Rules

Rate Prescriptions from a Backward-looking Taylor-like Rule



*The Blue Chip Forecast-implied rates use headline CPI forecasts, not core PCE forecasts.

Macroeconomic Advisers forecast prepared December 23, 2009.

When? Why Might the Fed Exit “Early”?

- Emergence of an asset bubble (or asset bubbles)
- Rise in LT inflation expectations => loss of credibility
- Collapse in the dollar

How? Exit Strategy

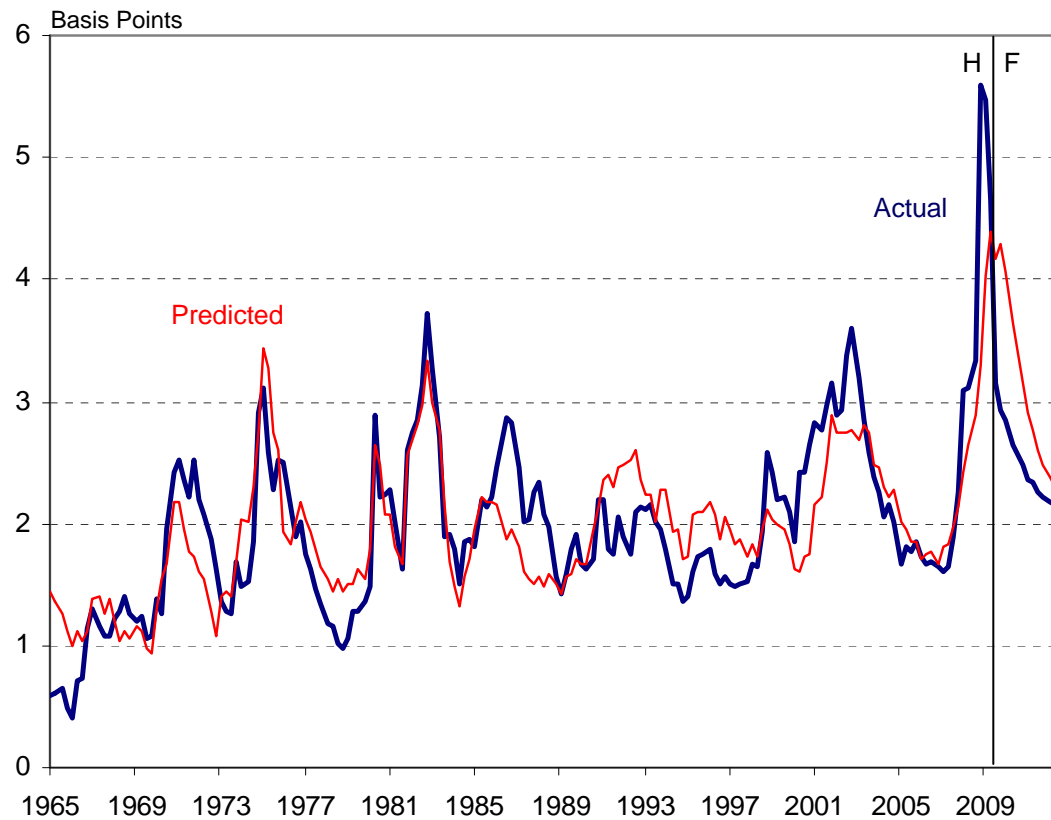
- End Easing
 - End Securities Purchase Programs
- Passive steps
 - Close Liquidity Facilities
 - Runoff
- Active steps
 - Raise Interest on Reserves (IOR)
 - Actively Withdraw Reserves (reverse repos, term deposits)
 - Shrink the Balance Sheet (asset sales vs. runoff)

Other Influences on Interest Rates

- Budget Policy: Deficits and Debt
- Monetary Policy and the Yield Curve
- Inflation Expectations and the Yield Curve
- Monetary Policy Response to Asset Bubbles
- Asset Sales and Mortgage Spreads
- Relapse of Financial Instability

Rates and Spreads

Baa Credit Spreads Relative to Predicted Spreads



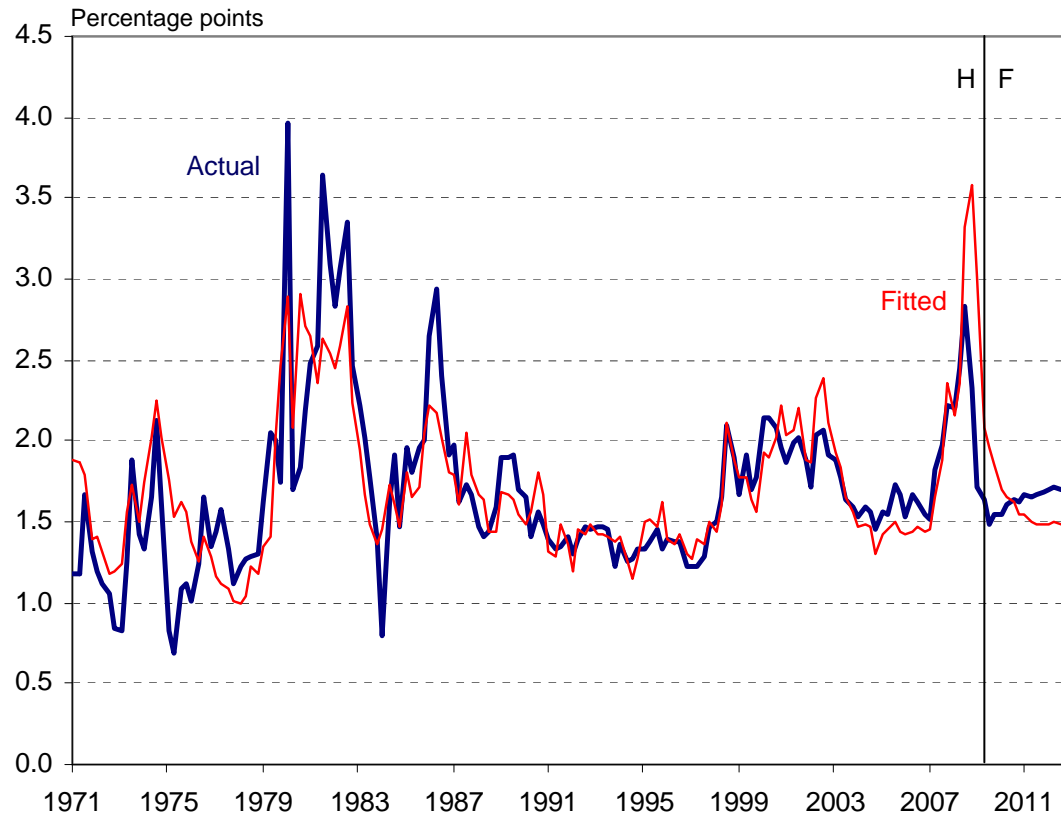
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MBS and Interest Rates

- MBS and Mortgage Spreads
 - Market impact of MBS purchases?
 - Perhaps 50 – 100 basis points
- The Market Impact of Ending Purchases
 - Uncertain (stock vs flow perspectives)
 - Inform whether or not to sell later
 - Dudley: via market, $\frac{1}{4}$ to $\frac{1}{2}$ percentage point
- Options for Selling MBS
 - Not at all; rely exclusively on runoff
 - Early to withdraw reserves and tighten financial conditions
 - Later (but gradually) to shrink balance sheet
 - Controversial, but gradual sales likely

MBS and Mortgage Spreads

Conforming Mortgage Spread



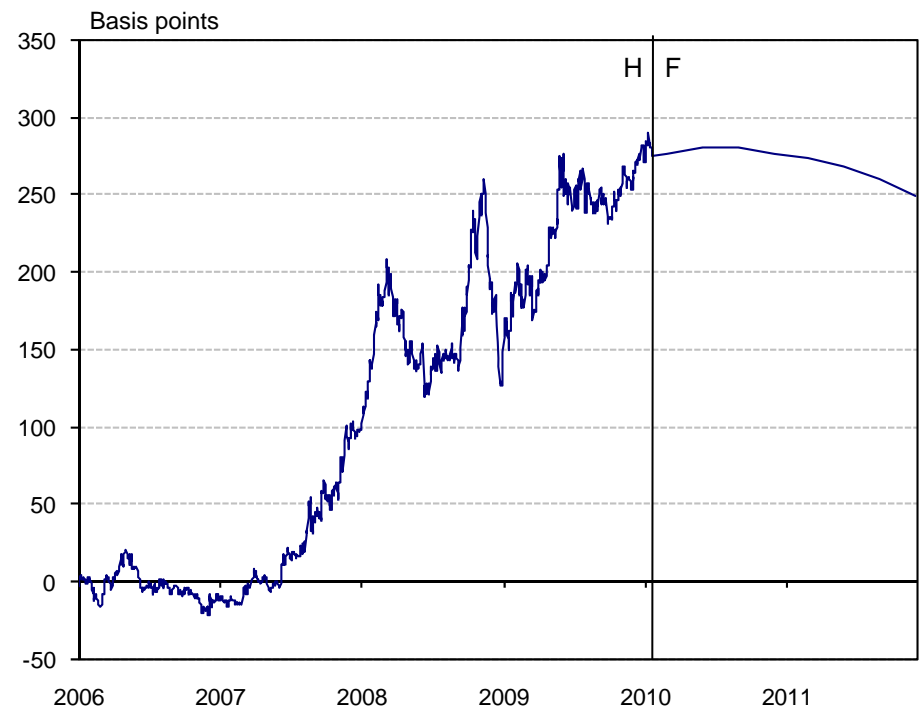
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The Yield Curve

Fed Funds Rate-2 Year Spread



2-10 Spread



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