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Views on the U.S. Economy: A Four-Part Story

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Any opinions expressed here are my own and do not necessarily reflect those of others on the Federal Open Market Committee.

This talk

- Monetary policy remains ultra-easy.
- U.S. economic performance is likely to improve in the 2nd half of 2011 as key uncertainties unwind.
- The Fed cannot remedy a failure to raise the debt ceiling.
- How to think about a decade of growth driven in part by a housing bubble.

Monetary Policy on Hold

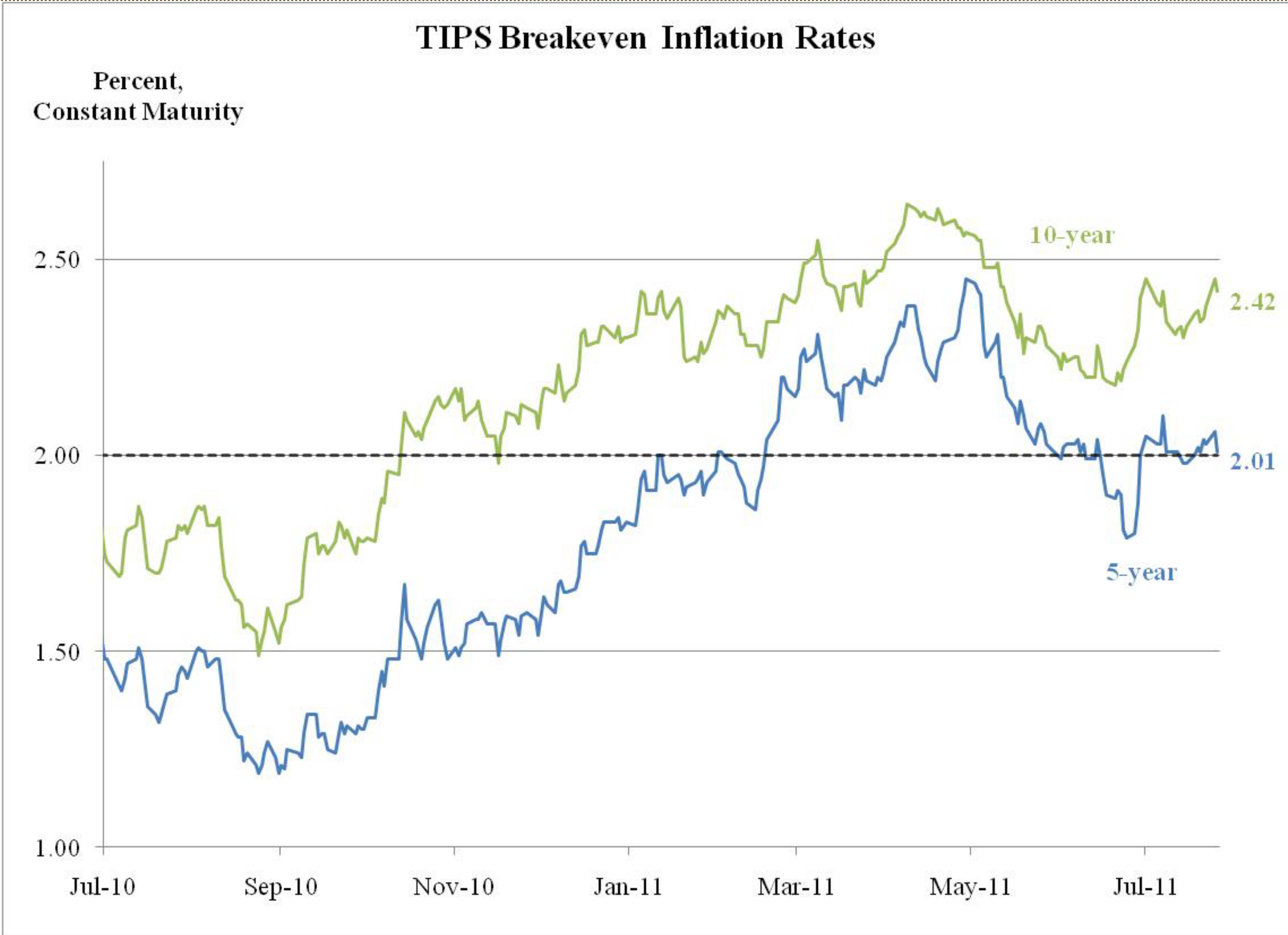
On hold at "ultra-easy"

- The Fed has taken extraordinary steps in recent years to try to run an effective counter-cyclical monetary policy.
  - Policy rate near zero.
  - "Extended period" language.
  - Expansion of the size of the balance sheet to a very high level.
- With the end of asset purchases associated with QE2, the size of the balance sheet remains at a high level.
- The Committee has not taken action to reduce the size of the balance sheet.

On hold at "ultra-easy"

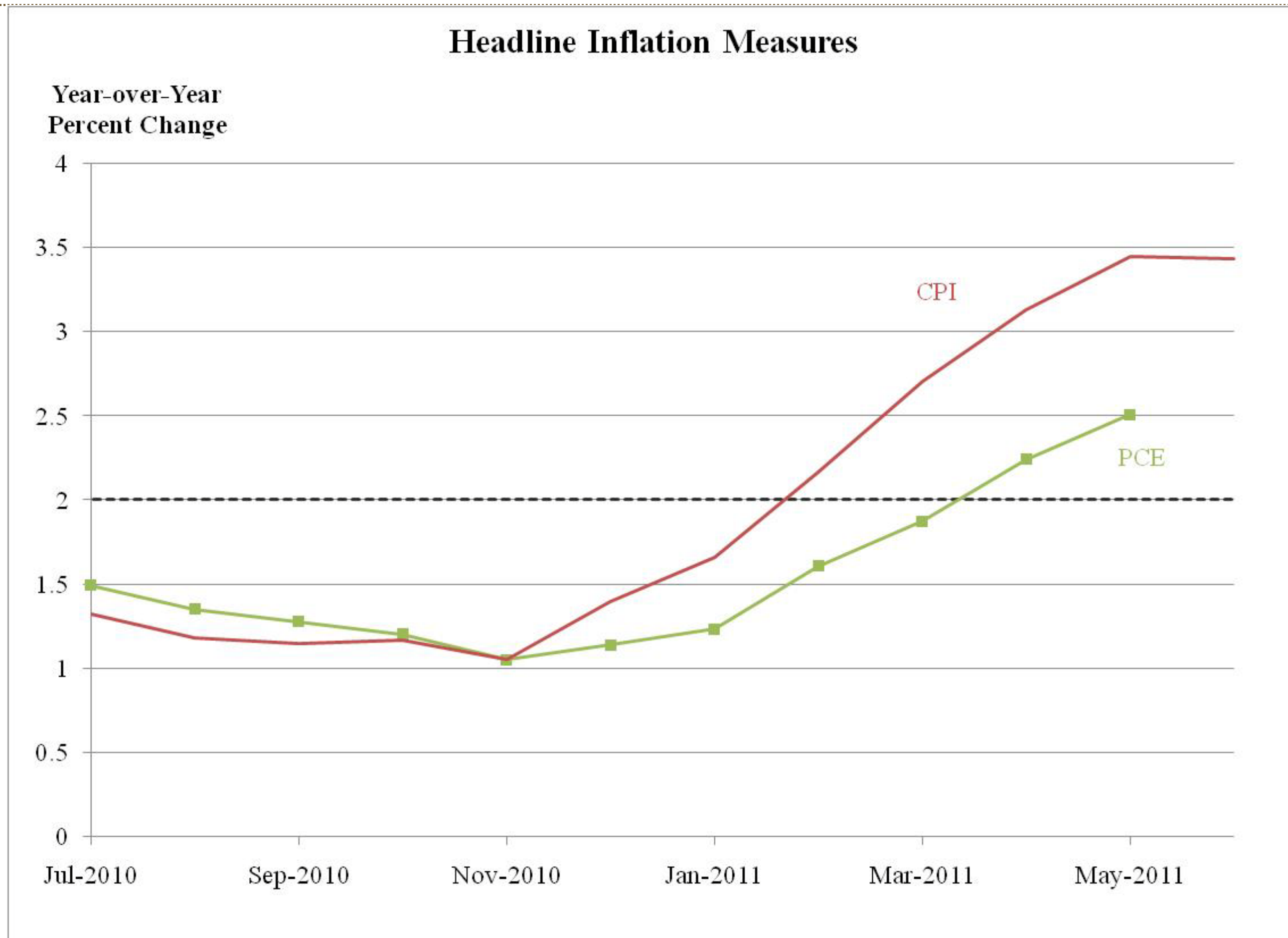
- The large balance sheet could generate significant inflation if accommodation is not removed at an appropriate pace.
- The inflationary threat has driven inflation expectations higher over the last year, and actual inflation has followed.
- With the policy rate at zero, this means real short-term rates have declined.
- That is, the policy stance has become even easier over the last year.
    - The market reaction has been standard: See my slides on "QE2: An Assessment."

Expected inflation



Source: Federal Reserve Board. Last observation: July 26, 2011.

Headline inflation measures: CPI and PCE



Source: BLS and BEA. Last observation: June 2011 and May 2011.

On hold at "ultra-easy"

- The FOMC has not taken any action so far to remove this inflationary threat.
- I conclude that monetary policy remains "ultra-easy" for now.
- This is an appropriate setting for monetary policy today.
- However, I expect that the economy will improve during the second half of the year and into 2012.
- As it does the FOMC will have to monitor the situation closely in order to remove accommodation at an appropriate pace.

The Second Half of 2011

Why economic performance will likely improve

- Four uncertainties have plagued the U.S. economy since February 2011.
- Each of these in principle could be large enough to derail global economic growth.
- Three of them have been largely or partially resolved, and one remains on the table.
- Once this last uncertainty is resolved, the path to faster growth may be open.

Why economic performance will likely improve

- The situation in Japan.
- Energy and commodity prices.
- The ongoing European sovereign debt crisis.
- The U.S. fiscal situation.

Japan

- The situation in Japan has stabilized and supply disruptions stemming from that source are expected to be minimal during the 2nd half of 2011.

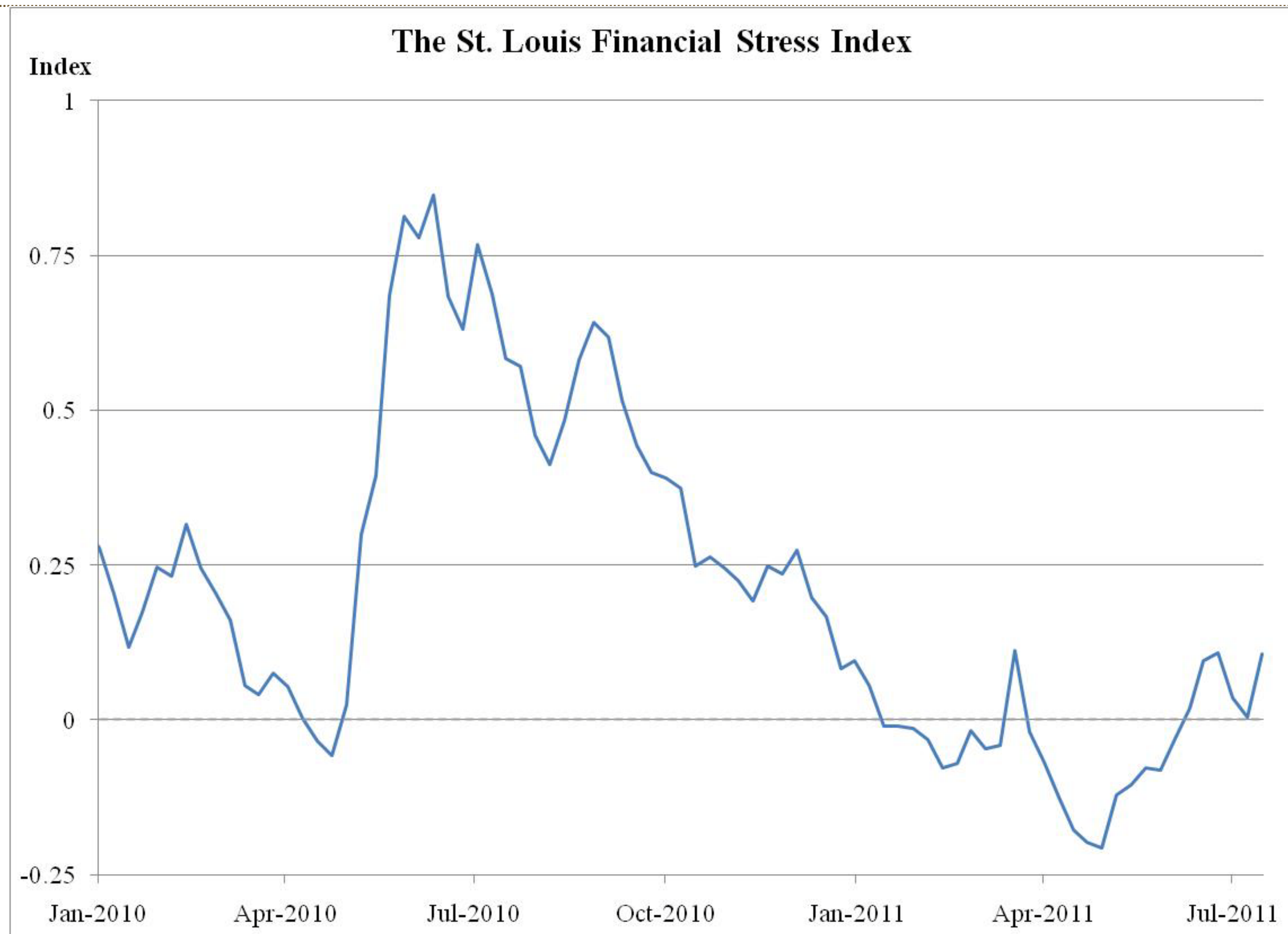
Energy and commodity prices

- Energy and commodity prices, especially oil prices, have moved off their highs earlier this year.
- Turmoil in the Middle East and North Africa has moderated.
- Consumers did not react to $4/gallon gasoline as negatively as they did in 2008.
  - Hamilton hypothesis vindicated.

European sovereign debt crisis

- Some progress has been made on Greece with the announcement of a new agreement in recent days.
- Financial stress indicators have not reacted as negatively to ongoing negotiations in Europe as they did in the April-May 2010 period.

Financial stress index



Source: Federal Reserve Bank of St. Louis. Last observation: Week of July 15, 2011.

The Fed and the Debt Ceiling

U.S. fiscal situation

- It is essential that the Congress and the President come to an agreement on the U.S. budget and the projected level of U.S. debt going forward.
- There is a substantial opportunity to put the U.S. fiscal situation on firmer footing, and remove a cloud of uncertainty hanging over U.S. macroeconomic prospects.
- Some damage has already been done, as the U.S. AAA debt rating is in peril, something that has not been at risk for the U.S. in recent history.

The Fed and the debt ceiling

- The Fed by law cannot buy debt directly from the Treasury.
- The Treasury must float the debt in the primary market first, and at that point the Fed can conduct open market operations.
- Hitting the debt ceiling means the Treasury cannot float debt in the primary market.
- Therefore, the notion sometimes floated in financial markets that the Fed can simply step in if necessary is incorrect.

The Fed and the debt ceiling

- The Fed has no options should the debt ceiling not be raised.
- This is as it should be, because otherwise the central bank would be thwarting the will of the Congress.
- The Chairman has emphasized this point.
- Should a general crisis ensue, the Fed can of course provide liquidity to markets as it did in 2008 and 2009. But that is not a substitute for the Treasury raising funds by issuing paper.

How to Think About a Bubble

Where is potential output today?

- The U.S. economy has been struggling to recover from a very large shock suffered during late 2008 and early 2009.
- Many give weight to the idea that a housing "bubble" collapsed.
- The data on housing prices certainly seems to support this hypothesis.
- What are the implications of a bubble of this nature for the economy?

Resource misallocation

- A "bubble" implies significant resource misallocation.
- The economic intuition is that too many resources were dedicated to the housing sector during the 2001 to 2007 period.
- The resources went to the housing sector directly, but also to related businesses that support that sector.
- This temporarily contributed to more rapid GDP growth than would have occurred otherwise, but was ultimately unsustainable as the bubble collapsed and caused a large recession.

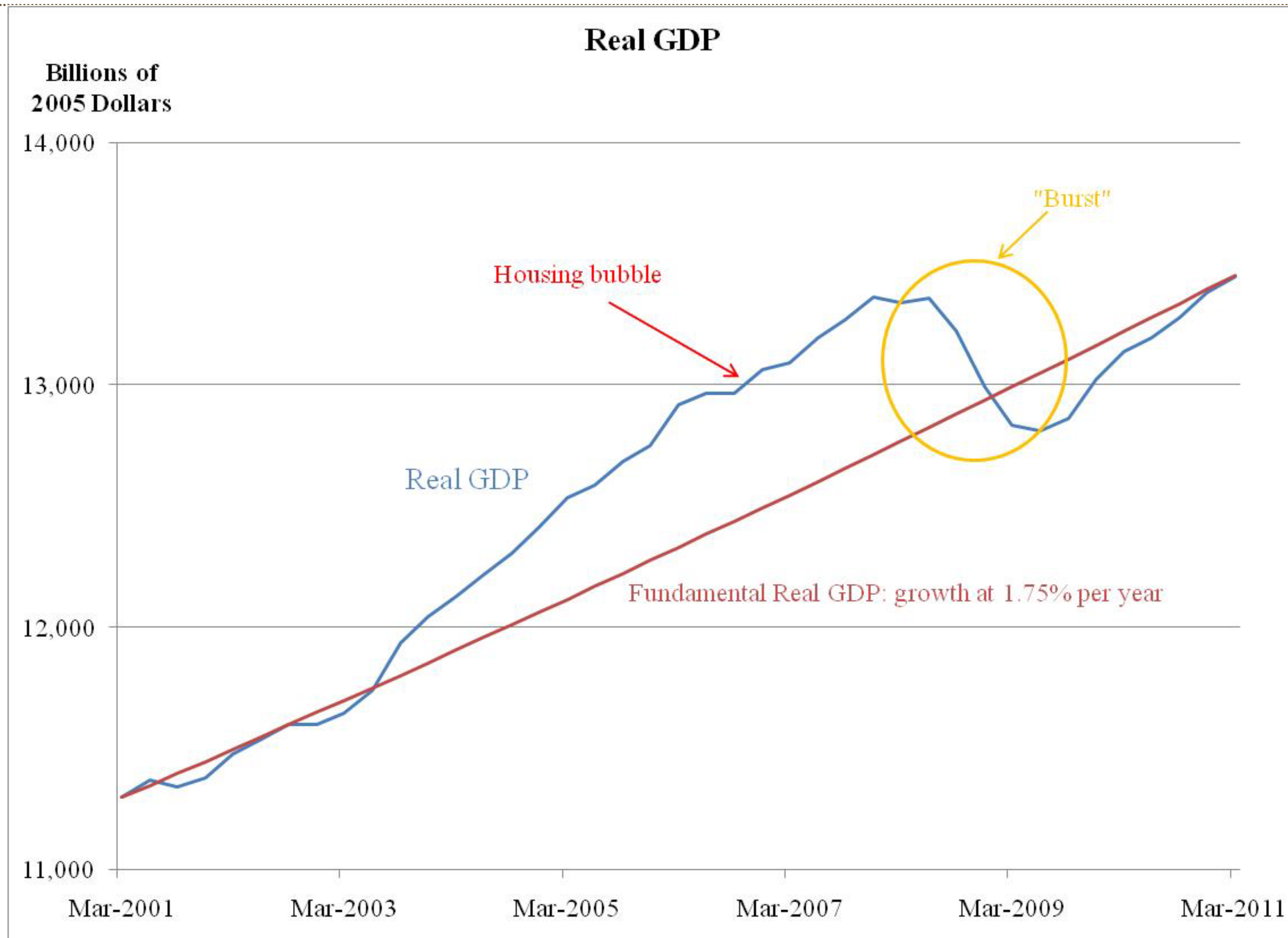
A simple calculation

- U.S. real GDP grew at a rate of about 2.4 percent on average from 2001 to 2007.
- Let's suppose the bubble contributed 0.65 percentage points on average to this growth, and the remaining 1.75 percentage points is due to fundamental factors.
- A bubble means that there was overinvestment in housing—driven by self-fulfilling beliefs *alone* concerning future housing prices being ever higher.
- In 2008 and 2009, a large recession occurs as the bubble unwinds.

Two economies

- This story suggests looking at two economies.
- The first economy is the fundamental one which grows steadily at 1.75 percent per year.
- The second economy is the bubble economy which temporarily grows at a faster rate, but ultimately crashes and returns to the fundamental growth rate.
- The bubble economy is more volatile and because the bubble sector initially grows rapidly and subsequently collapses, labor markets are significantly disrupted.

Two economies: Real GDP



Source: Bureau of Economic Analysis and author's calculations. Last observation: 2011-Q1.

How to think about a bubble

- If the bubble explanation is correct, we should be comparing today's output level to the level suggested by the underlying, non-bubble, fundamental economy that would have existed over the last decade.
- This gives a very different perspective on where the economy is today.
- This calculation could be done in a variety of ways and is only meant to be suggestive.

How to think about a bubble

- Nearly all analysis today that I see compares today's level of output to the peak level produced during the last decade.
- Comparing today's economy to the peak of the bubble is inappropriate, unless:
  - There was no housing bubble and the economy was driven entirely by fundamentals.
  - The appropriate policy is to re-inflate the bubble that existed.
- Both of these strain credulity.

Conclusions

Recap

- Monetary policy is on hold in an ultra-easy mode.
- I continue to expect U.S. economic performance to improve in the 2nd half of 2011.
- The Fed cannot remedy a failure to raise the debt ceiling.
- If the U.S. economy was distorted by a housing bubble in the last decade, as many believe, then the appropriate comparison of today's output level is to the non-bubble, fundamental level of output that would have been produced.

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