The U.S. Economy in the Aftermath of the Financial Crisis

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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.

Four themes

- The FOMC adopts inflation targeting.
- Brighter prospects for the U.S. economy.
- Ongoing problems in U.S. housing markets: A collapsed real estate bubble.
- New policy tools at the Fed.

Inflation Targeting in the U.S.A.

The FOMC sets an inflation target

- At the January 2012 meeting, the Federal Open Market Committee (FOMC) named an explicit, numerical inflation target of 2 percent.
- The Fed joins many central banks around the world in adopting an inflation target.
- Chairman Bernanke's goal since joining the Fed.
- Congratulations to the Chairman on this important accomplishment.

Inflation means headline inflation

- Inflation is measured by the personal consumption expenditures (PCE) price index.

- It is the headline index that is targeted.
  - It does not make sense to ignore some inconveniently volatile prices, like those for gasoline and food.

- Headline PCE inflation measured from one year ago is 2.4 percent, somewhat above target.
  - This measure has been falling in recent reports.

Inflation targeting and stabilization policy

- Inflation targeting emphasizes control over inflation as the key long-term goal of monetary policy.
- The actions of the FOMC can also temporarily influence the direction of the economy in the short run.
  - This influence can help to smooth macroeconomic fluctuations.
  - This is known as monetary stabilization policy.
- An inflation target combined with a sensible stabilization policy is often called *flexible inflation targeting*.
- This is the policy the FOMC has adopted and that follows the practice of many other central banks.

Flexible inflation targeting

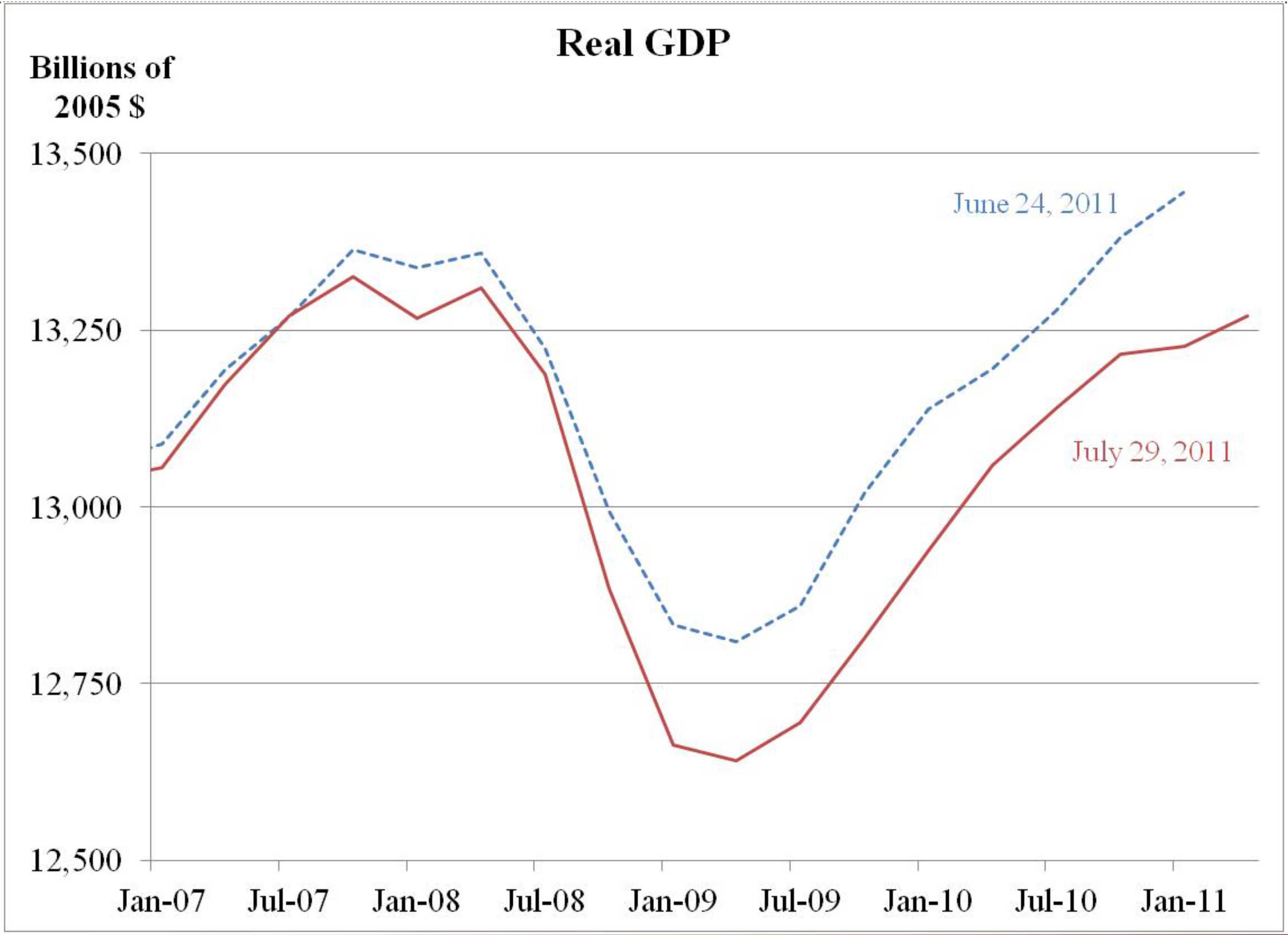
- Flexible inflation targeting enables a central bank to conduct stabilization policy without compromising the longer-run goal of keeping inflation low and stable.
- The 1970s experience with double-digit inflation was accompanied by especially poor macroeconomic performance.
- The lesson: Allowing high inflation just causes problems and does nothing to address fundamental macroeconomic issues.

Brighter Prospects for the U.S. in 2012

The recession scare

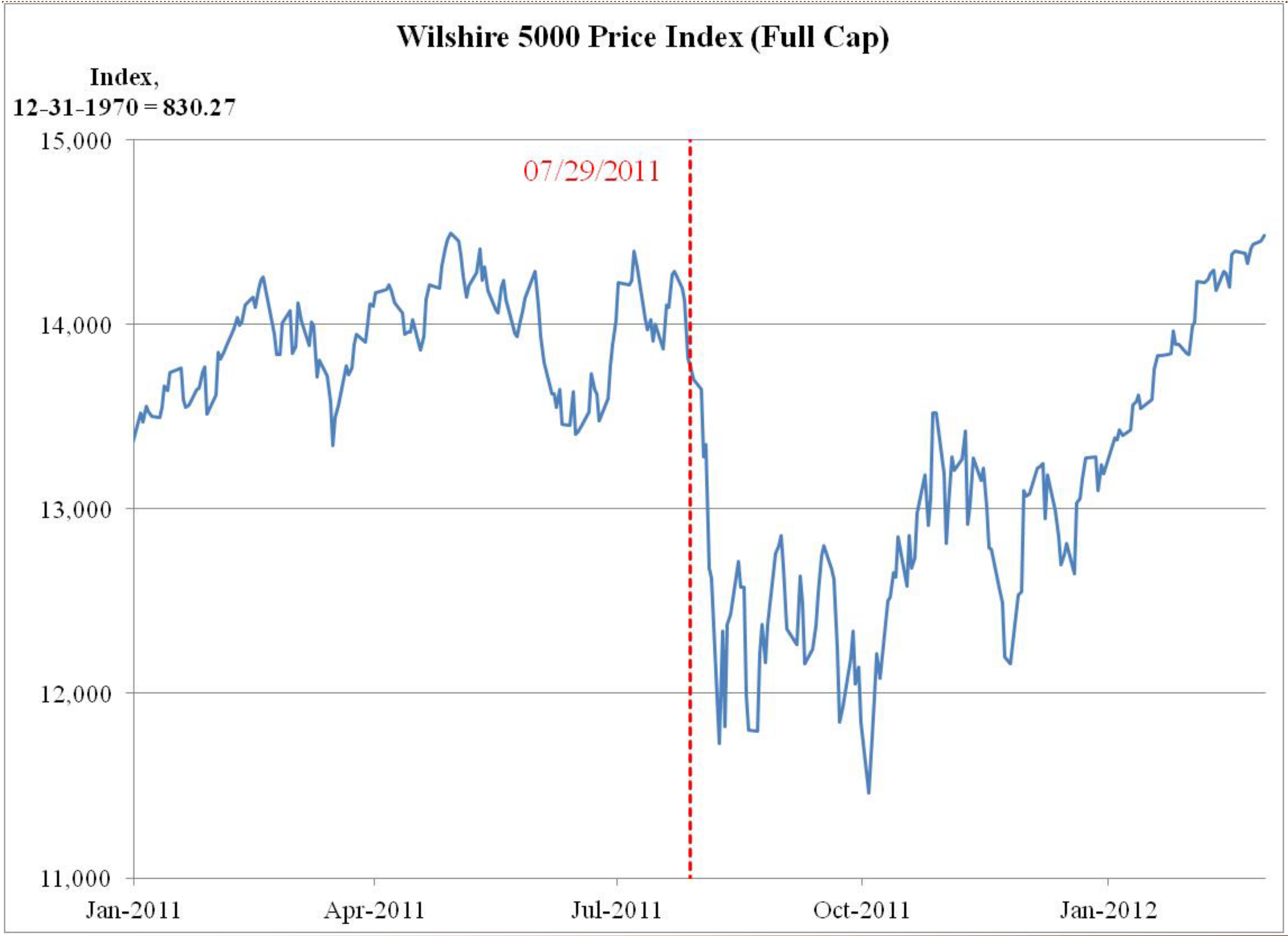
- Last August, forecasters marked up the probability that the U.S. would fall into recession during the second half of 2011.
- Most of this was because of the July 29th GDP report.
- The debt ceiling debate and the European sovereign debt crisis damaged household and business confidence.
- However, household and business behavior did not change by enough to validate the recession predictions.

The entire path of GDP marked down



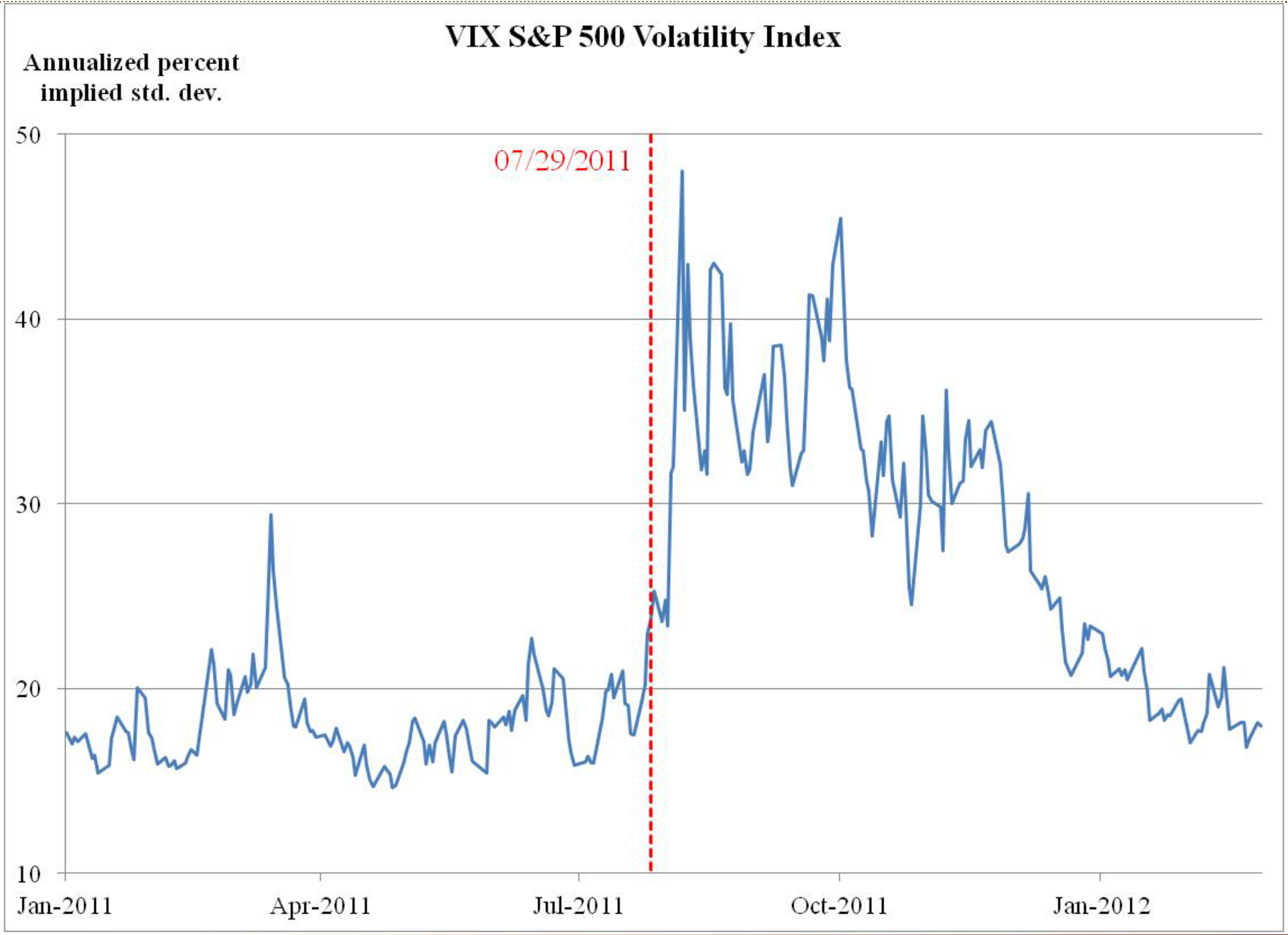
Source: Bureau of Economic Analysis. Last observation: 2011-Q2.

Equity valuations fell sharply



Source: Wall Street Journal. Last observation: February 28, 2012.

U.S. market volatility increased



Source: Wall Street Journal. Last observation: February 28, 2012.

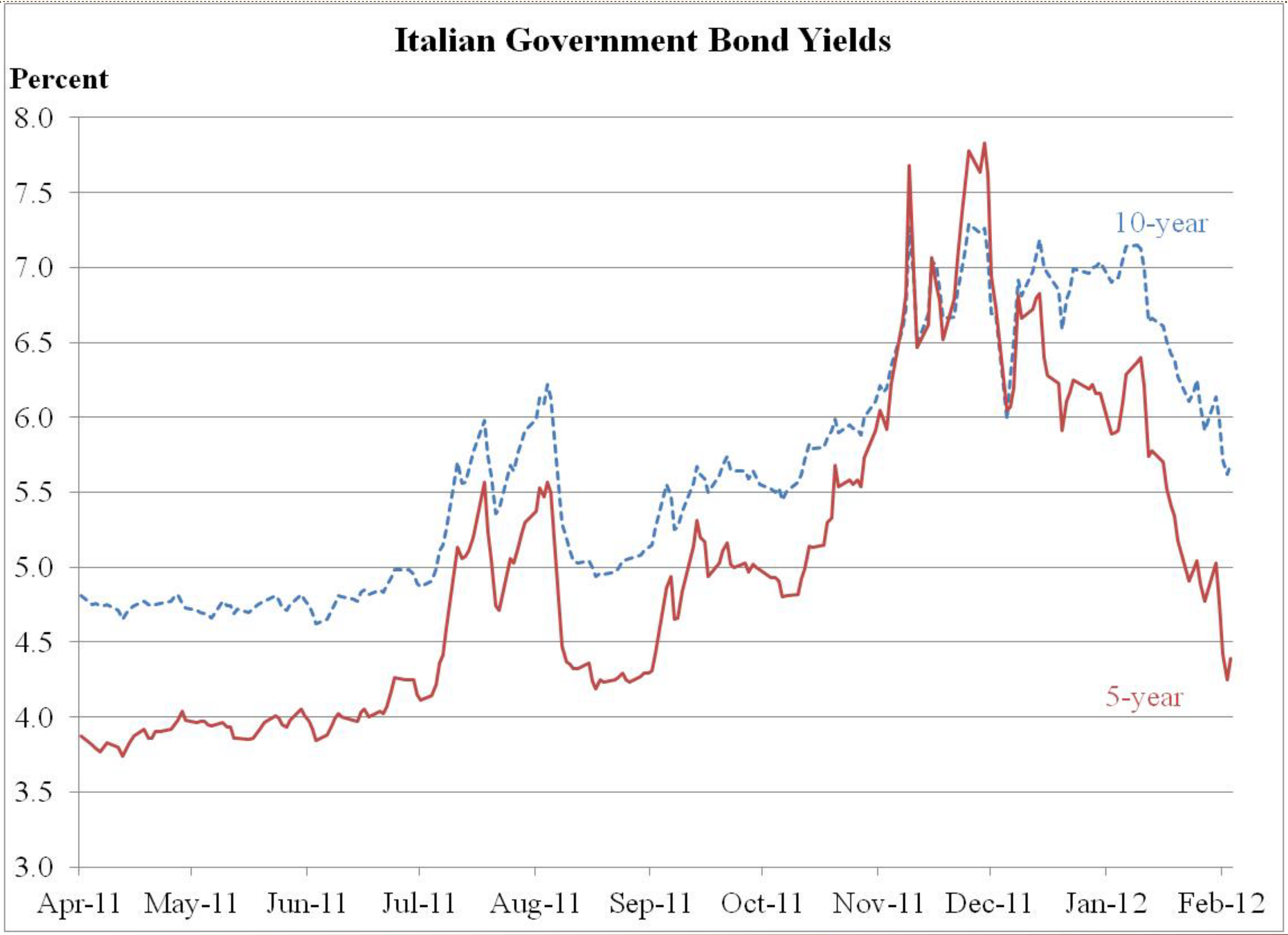
The effects of consumer confidence

- U.S. households remain nervous due to the headlines from Europe, but in general Europe is viewed as too distant to force them to change behavior in a major way.
- So, despite drops in confidence last summer, hard data on the U.S. economy continued to show moderate growth.
- Since last summer, household confidence has increased.

ECB long-term refinancing calms markets

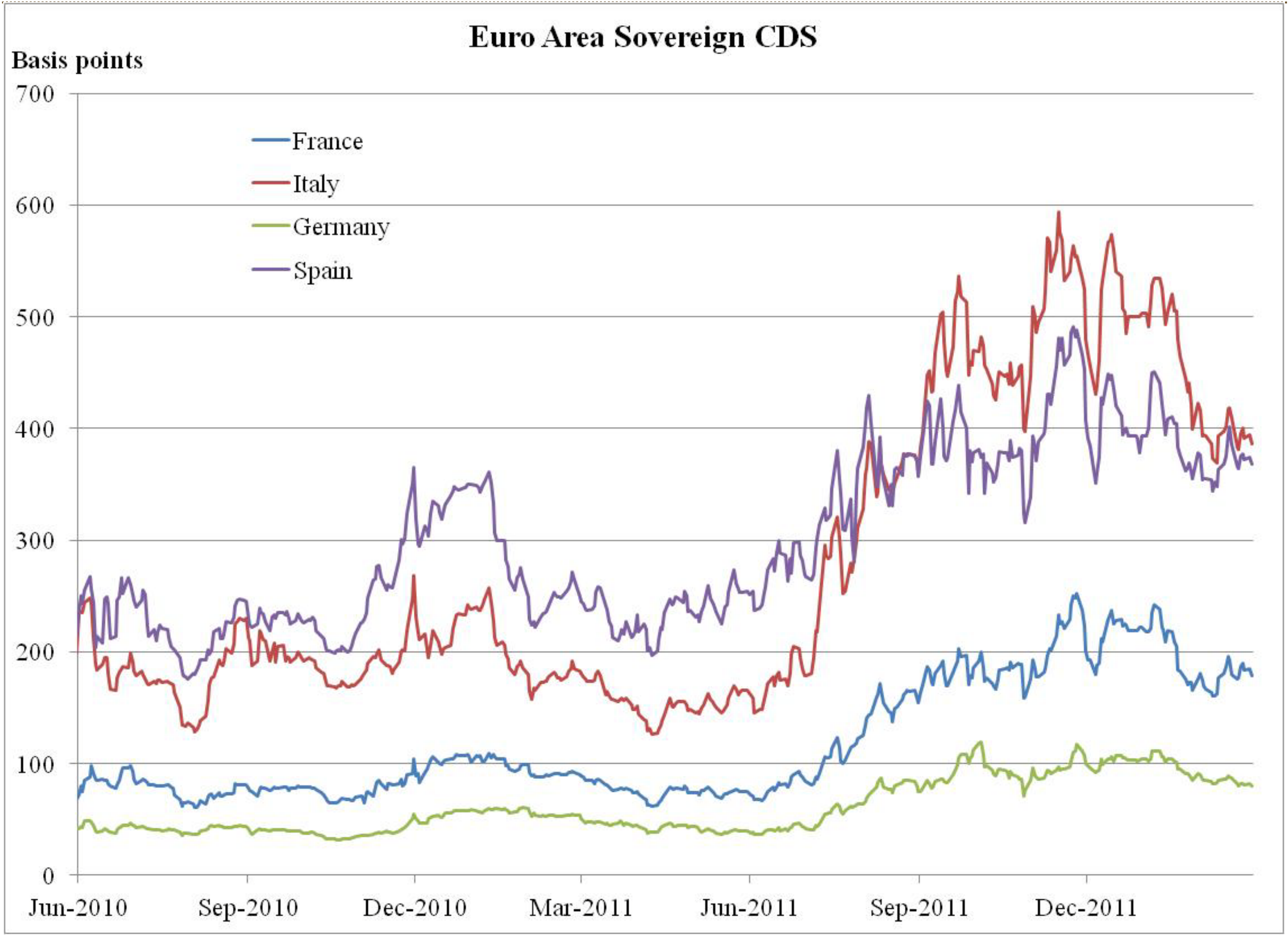
- The ECB offered three-year refinancing at low rates on broadened collateral in December.
- A second tranche, worth about $713 billion, was offered recently.
- At least for now, this has calmed European markets relative to last fall.

European markets calmer



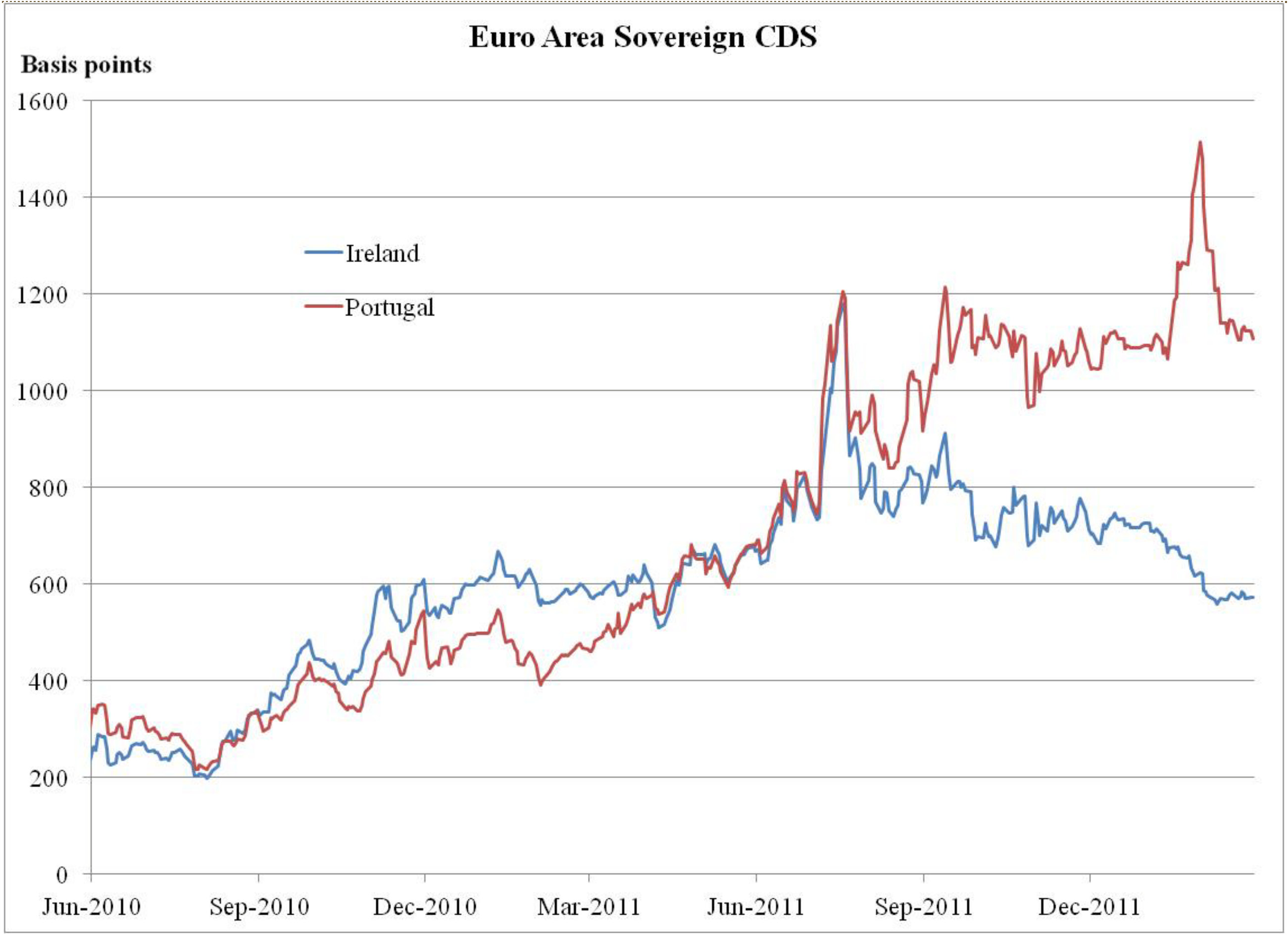
Source: Reuters. Last observation: February 28, 2012.

European CDS still elevated



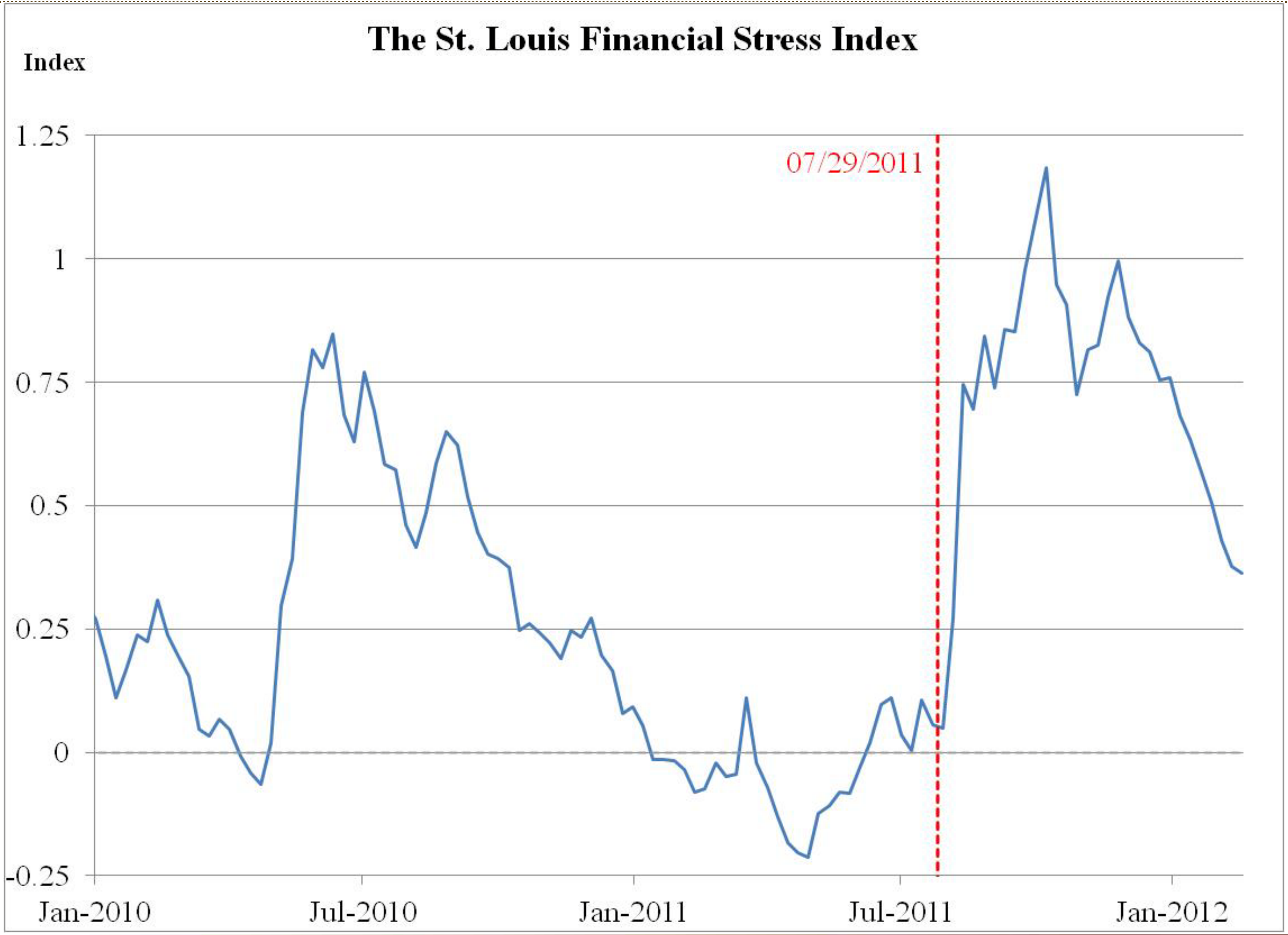
Source: Federal Reserve Bank of New York. Last observation: February 28, 2012.

European CDS still elevated



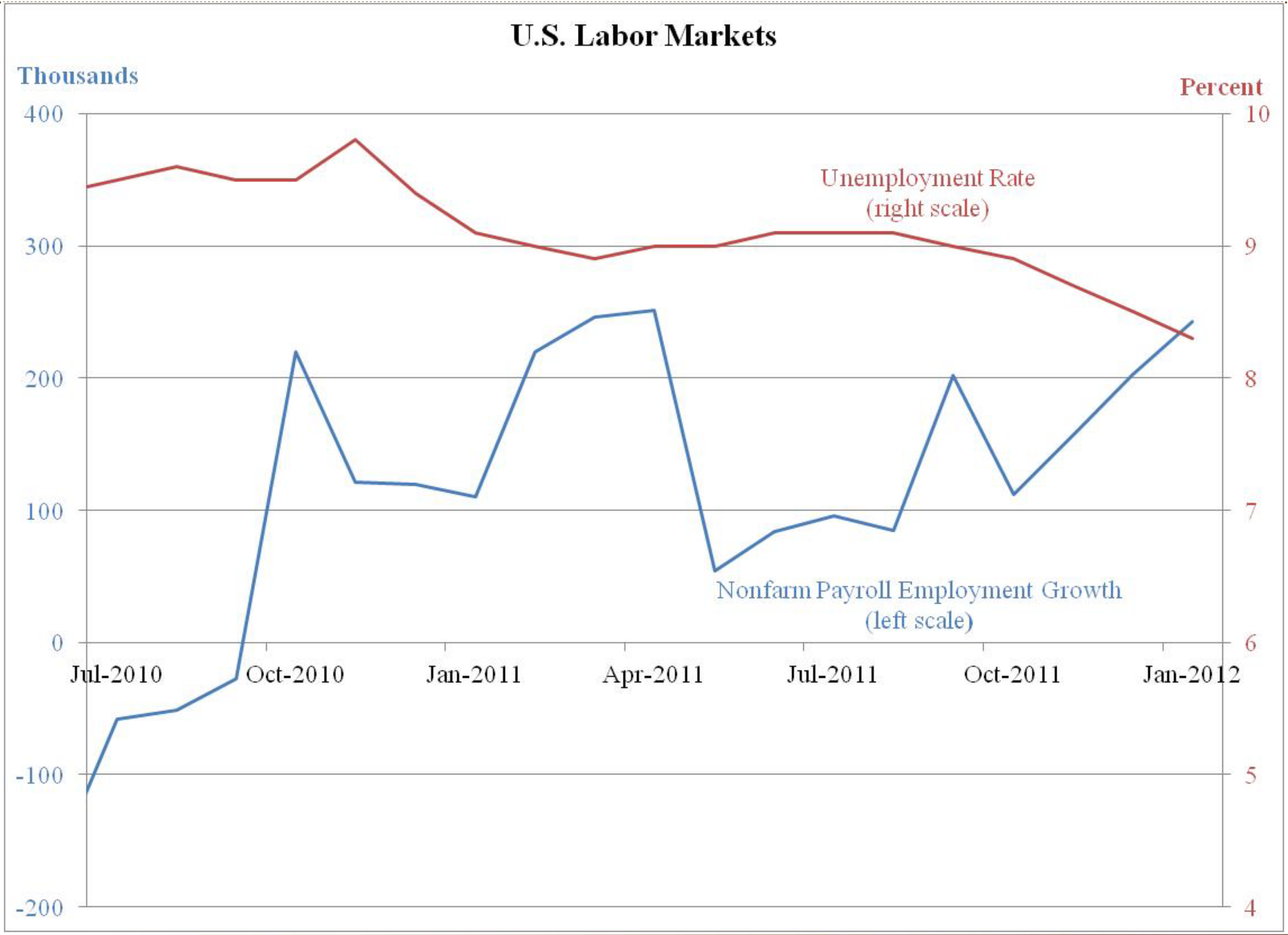
Source: Federal Reserve Bank of New York. Last observation: February 28, 2012.

Financial stress falls in the U.S.



Source: Federal Reserve Bank of St. Louis. Last observation: week of February 17, 2012.

Improvement in U.S. labor markets



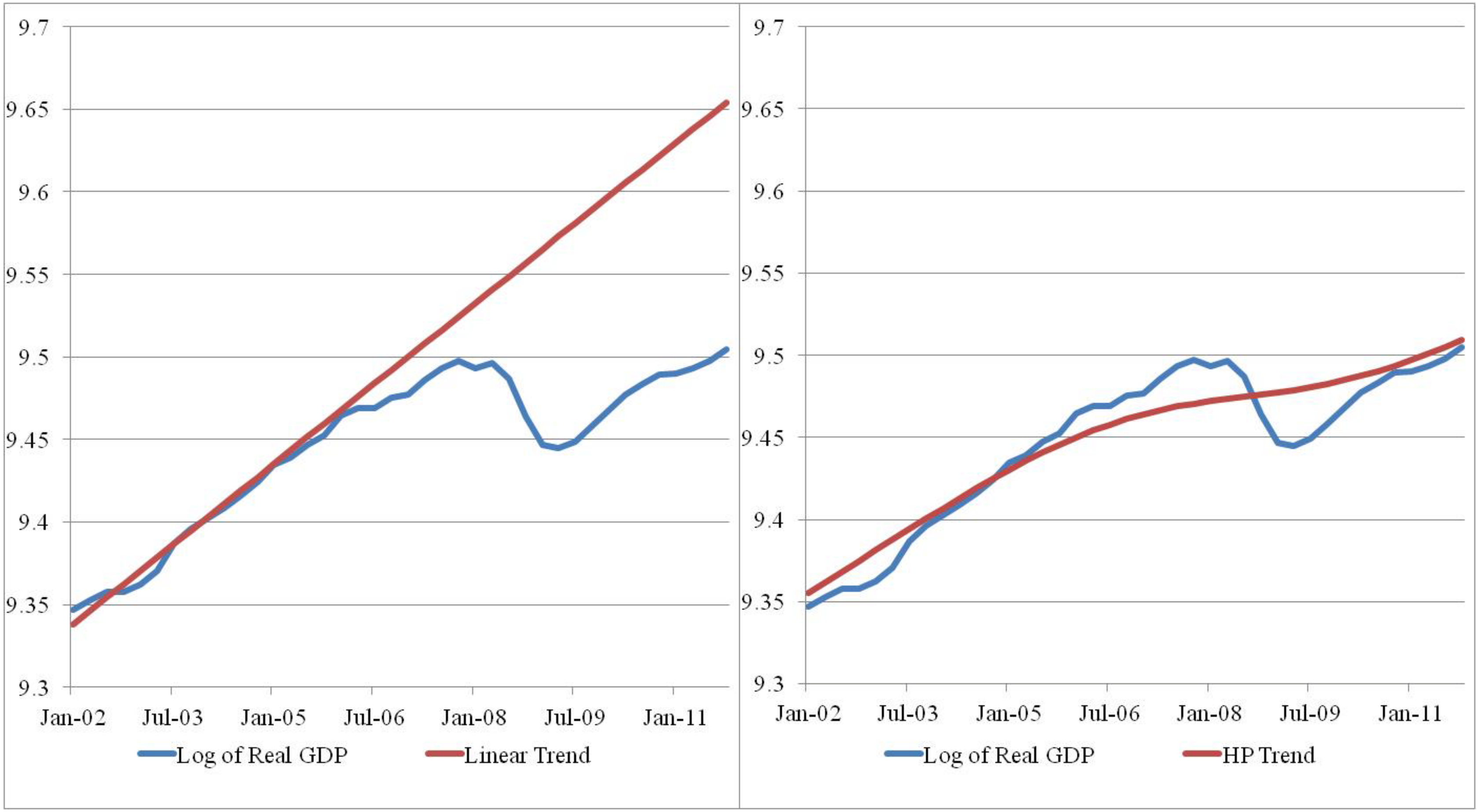
Source: Bureau of Labor Statistics. Last observation: January 2012.

U.S. Housing Markets

Collapse of a housing bubble

- Most components of U.S. GDP have recovered to their 2007 Q4 peak.
- The exception is the components of investment related to real estate.
- These components of GDP will take a long time to recover.
- It is therefore not reasonable to claim that the "output gap" is exceptionally large.

Decomposing real GDP

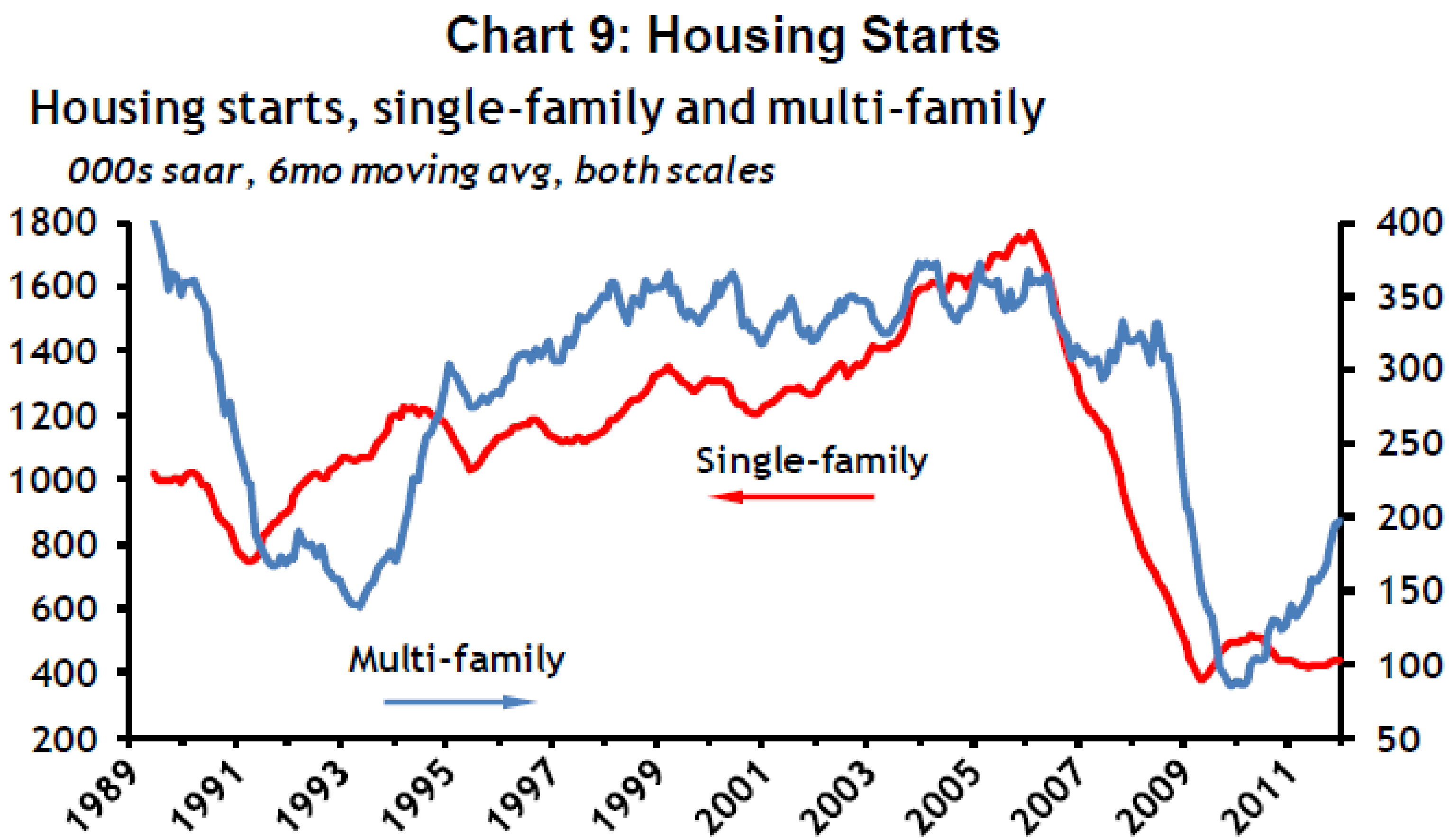


Source: Bureau of Economic Analysis and author's calculations. Last observation: Q4-2011.

Re-inflating the housing bubble?

- It is neither feasible nor desirable to attempt to re-inflate the U.S. housing bubble of the mid-2000s.
- The crisis has likely scared off a cohort of potential homeowners, who now see home ownership as a much riskier proposition than renting.

Housing Starts

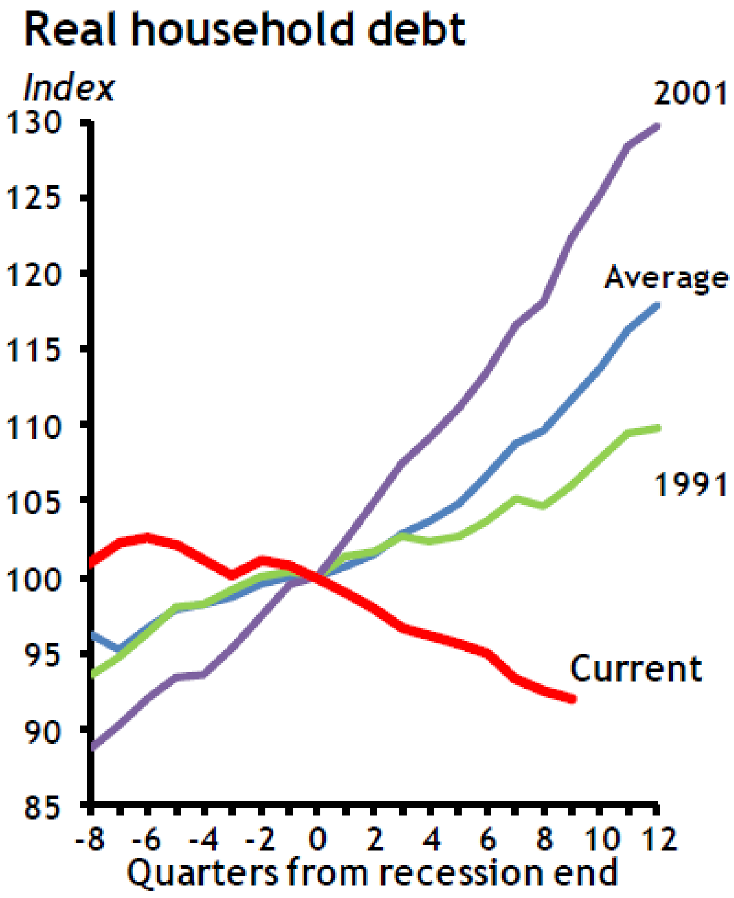


Source: Feroli et al. (2012).

Too much debt

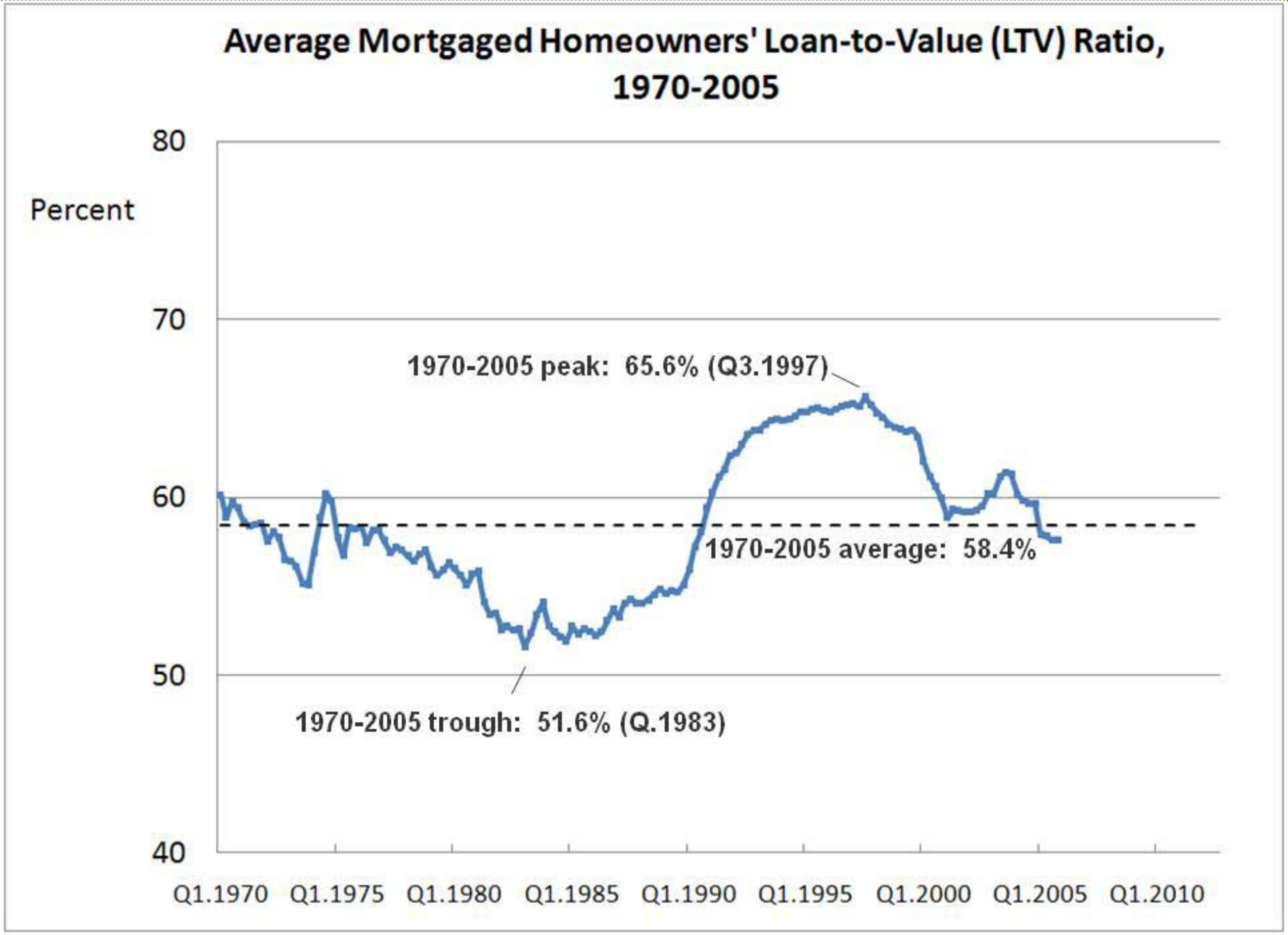
- The crisis has also saddled U.S. households with much more debt than they intended to take on.
- This is the first U.S. recession in which deleveraging has played a key role.

Real household debt



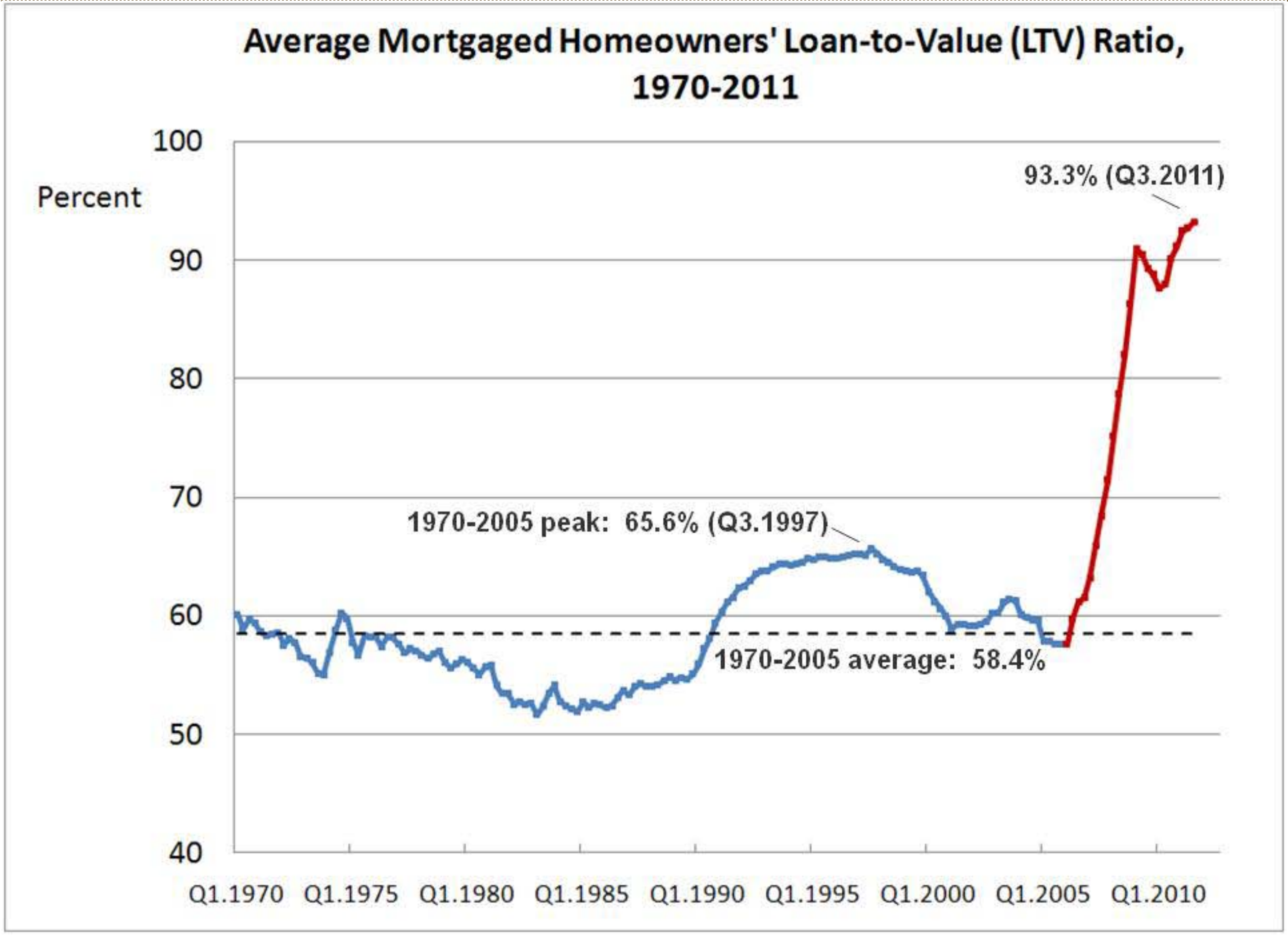
Source: Feroli et al. (2012).

Moderate LTV ratios



Source: Federal Reserve Flow of Funds Accounts *and* Survey of Consumer Finances; *author's calculations.*
Last observation: Q3-2011.

… until house prices crashed



Source: Federal Reserve Flow of Funds Accounts *and* Survey of Consumer Finances; *author's calculations. Last observation: Q3-2011.*

Too much debt

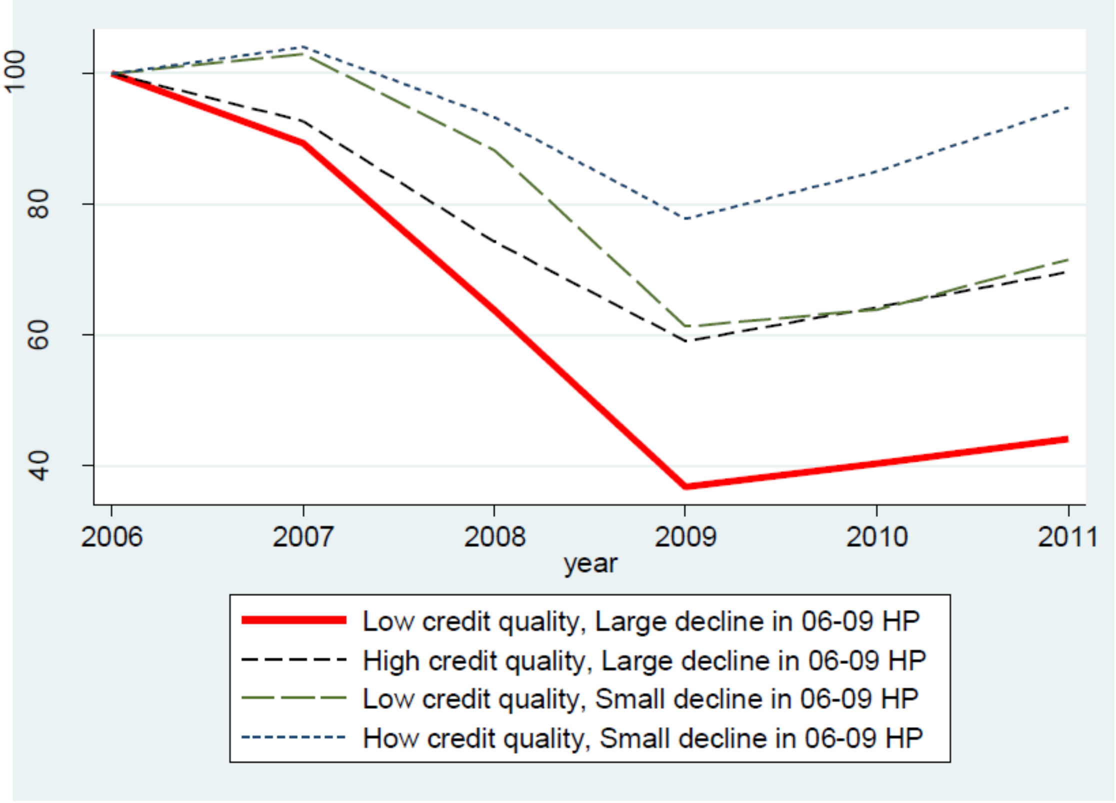
- Suppose we think of 58.4 percent as the “normal” loan-to-value ratio.
- U.S. homeowners have about $9.9 trillion in debt outstanding against $712 billion of equity.
- To get back to the normal LTV, households would have to pay down mortgage debt by about $3.7 trillion, about one-quarter of one year’s GDP.
- This will take a long time. It is not a matter of business cycle frequency adjustment.

Some households are constrained

- Feroli, et al., (2012) suggest that some households may not be able to react normally to easy monetary policy.
- This is because they cannot borrow more against their home values.
- Evidence: States with the largest declines in home values have the weakest recoveries.
- Monetary policy may not be able to reach the constrained households.

Auto sales by state and credit quality

Chart 22: Auto Sales for High and Low Credit Quality within Large and Small House Price Decline States



Source: Feroli et al. (2012).

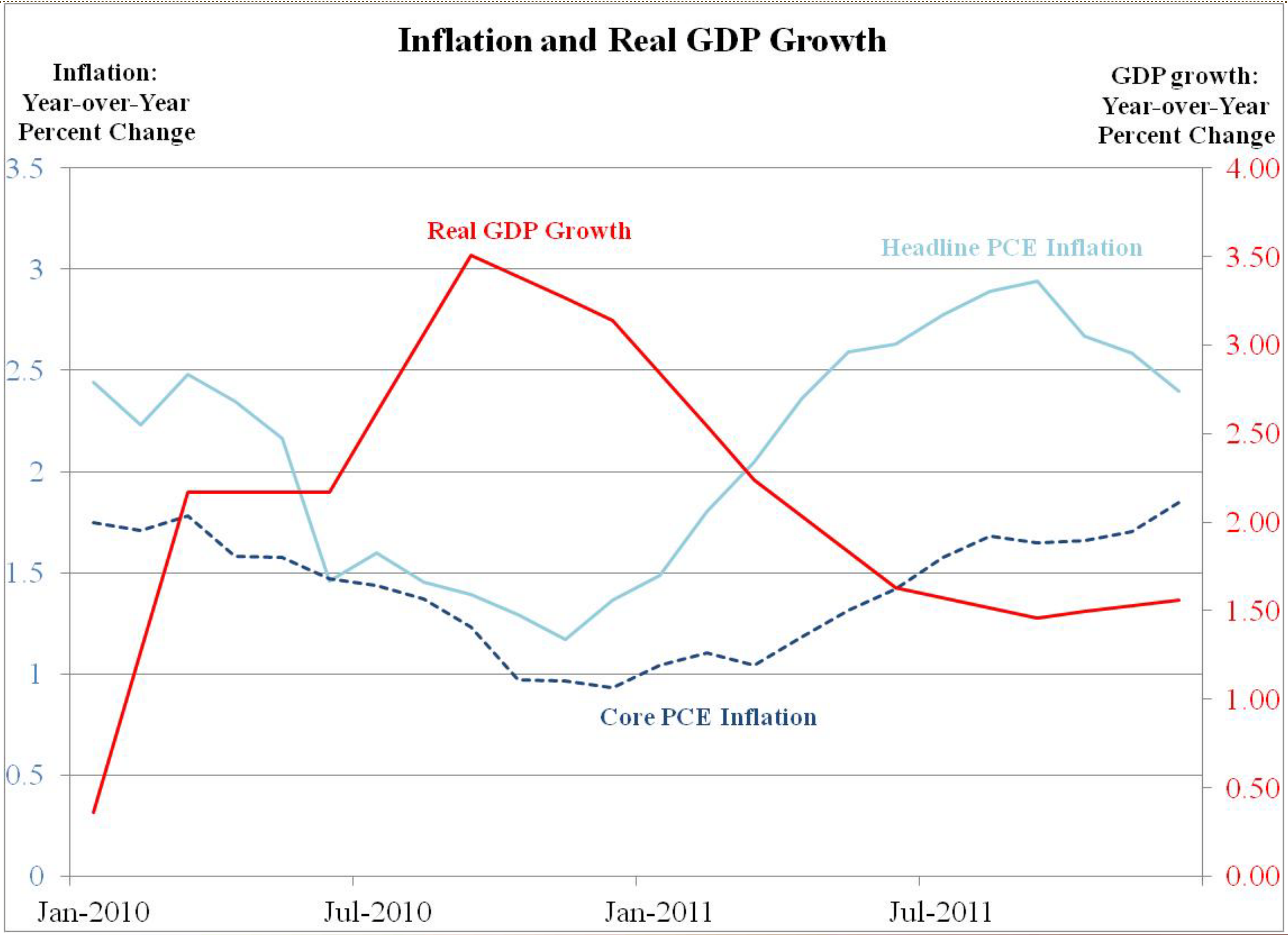
Recent Monetary Policy

Asset purchases

- Increases in the size of the balance sheet entail additional inflationary risks if accommodation is not removed at an appropriate pace.

- Inflation and inflation expectations rose during the last 18 months, even though many measures of economic performance indicate that the U.S. economy was relatively weak.

Inflation turns around



Source: Bureau of Economic Analysis and author's calculations. Last observations: December 2011 and 2011-Q4.

The communications tool

- The Committee could use the promised date of the first interest rate increase as the primary policy tool during the upcoming period of continuing near-zero policy rates.
- By shifting this date, the Committee, at least according to some models, can influence financial market conditions and provide further monetary accommodation if it so desires.
- The communications tool works inside models but has some important caveats for actual policy application.

The communications tool: credibility problems

- Namely, it is not clear how credible actual announcements can be.
- If the economy is performing well at the point in the future where the promise begins to bite, then the Committee may simply abandon the promise and return to normal policy.
- But this behavior, if understood by markets, would cancel out the initial effects of the promise, and so nothing would be accomplished by making the initial promise.
- A non-credible announcement would simply be unhelpful.

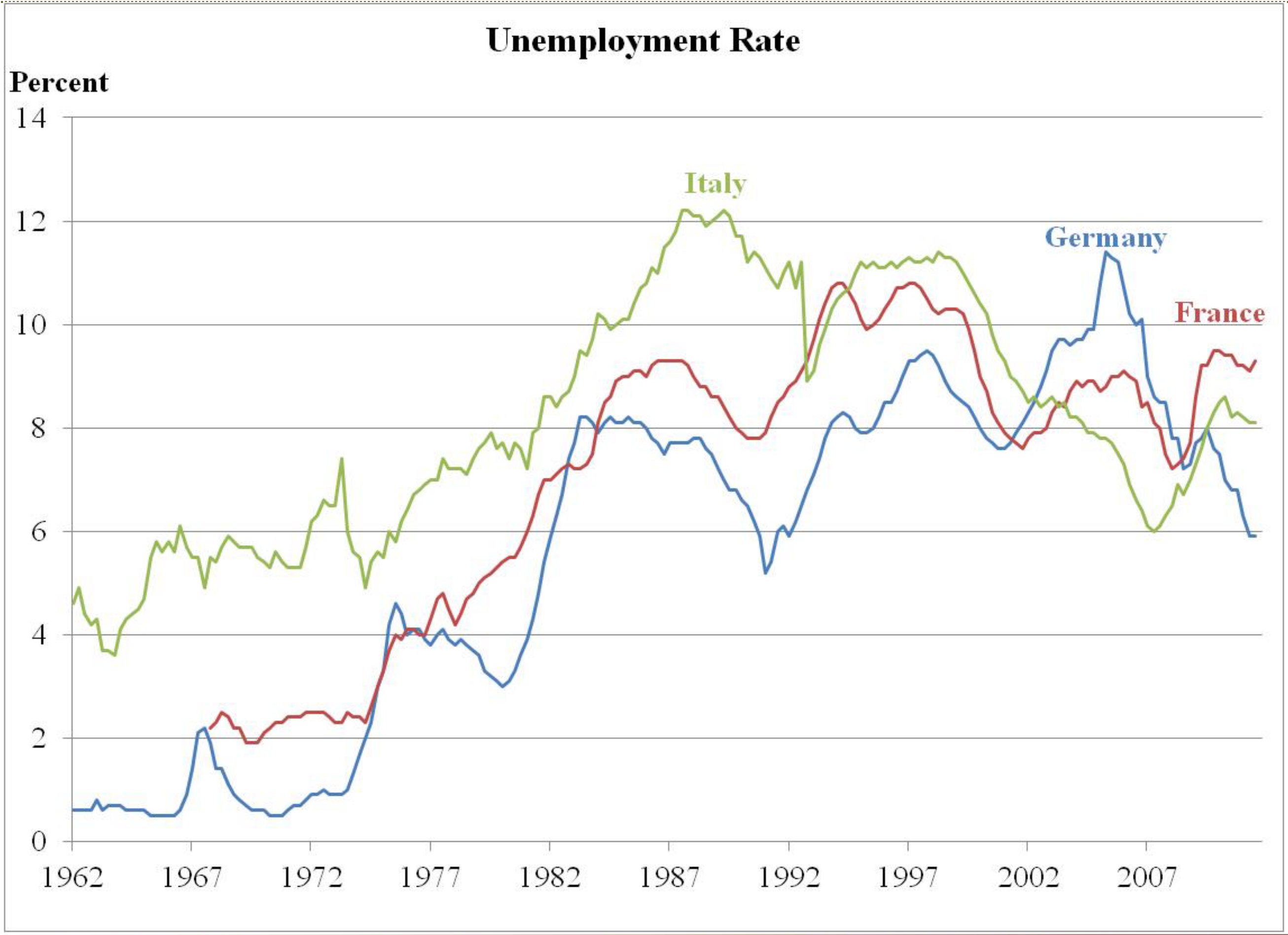
The communications tool: ties to actual outcomes?

- The Committee could also tie a promise of near-zero policy rates to actual outcomes in the economy, such as the unemployment rate.
- Most proposals use an *actual* unemployment rate but an *anticipated* inflation rate.
  - This asymmetry is hard to justify.
- Unfortunately, unemployment rates have a checkered history in advanced economies over the last several decades.

The communications tool: ties to actual outcomes?

- In particular, "hysteresis" has been a common problem—unemployment rises and simply stays high.
- This occurred in Europe during the last 30 years.
- If such an outcome happened in the U.S. and monetary policy was tied to a numerical unemployment outcome, monetary policy could be pulled off course for a generation.

European unemployment: hysteresis



Source: OECD Main Economic Indicators . Last observation: 2011-Q3.

Labor market policy

- The U.S. has about 13m unemployed people, against 142m employed and 88m out of the labor force.*
- Labor market policies such as unemployment insurance and worker retraining have direct effects on the unemployed.
- Monetary policy is a blunt instrument which affects the decision-making of everyone in the economy.
- In particular, savers are hurt by low interest rates.
- It may be better to focus on labor market policies to address unemployment instead of monetary policy.

** Source: Bureau of Labor Statistics. January 2012 data.*

Conclusions

Recap

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- New policy tools at the Fed.

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