Monetary Policy and the U.S. Economy

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Rogers, Arkansas

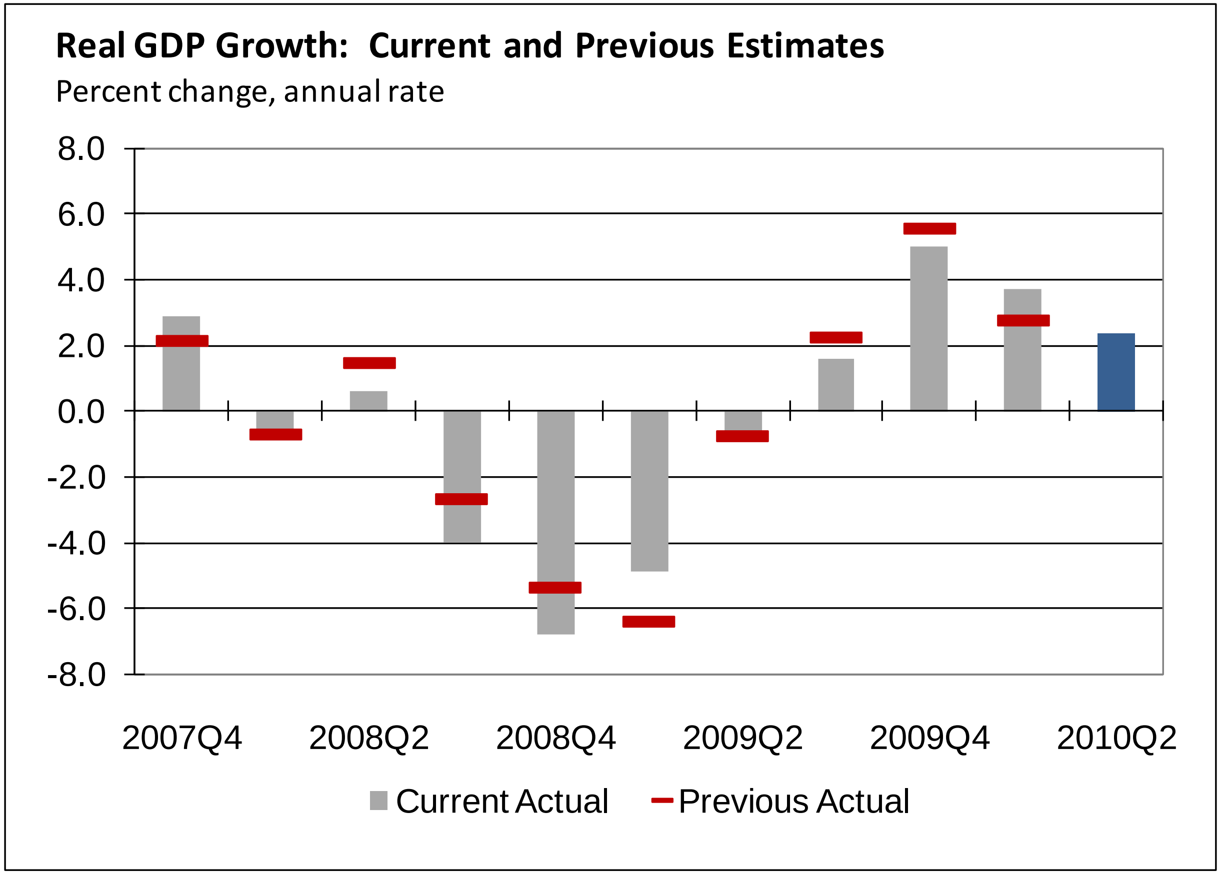
Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee members.

This talk

- The U.S. macroeconomic outlook has been downgraded, but remains positive going forward.
- The European sovereign debt crisis has abated somewhat but remains a factor in the global economic mix.
- Core inflation has fallen to low but still manageable levels.
- Any additional quantitative easing undertaken by the FOMC should be a disciplined reaction to further disinflation risks.

Outlook: Downgraded but still positive

NIPA revision:
The recession was deeper than initially estimated

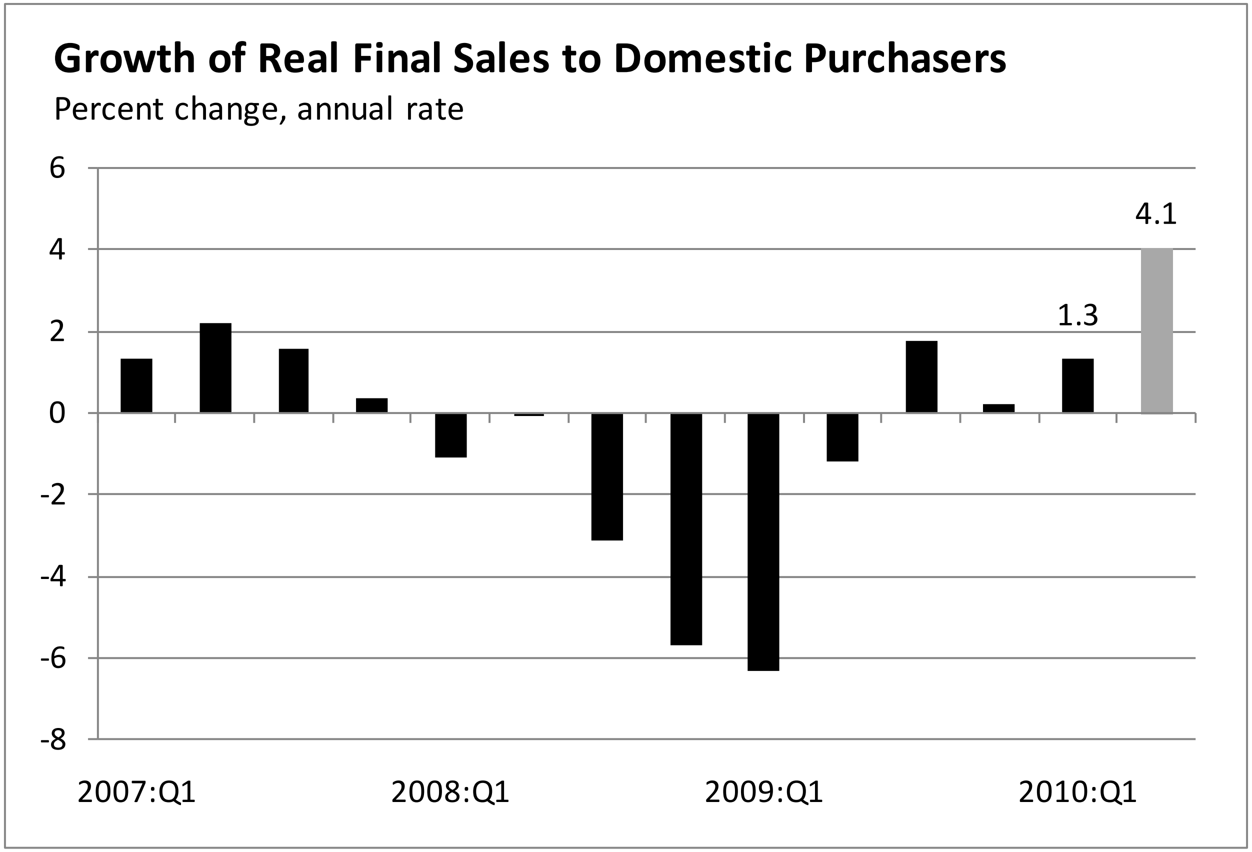


Source: Bureau of Economic Analysis. Last observation: Q2-2010.

Not all signals from GDP suggest slowing

- The second-quarter figure was influenced by imports.
- Economists sometimes consider domestic purchases as an indicator of household appetite for spending.
- Real final sales to domestic purchasers includes imports.

Growth of final domestic demand for Q2-2010 was strong

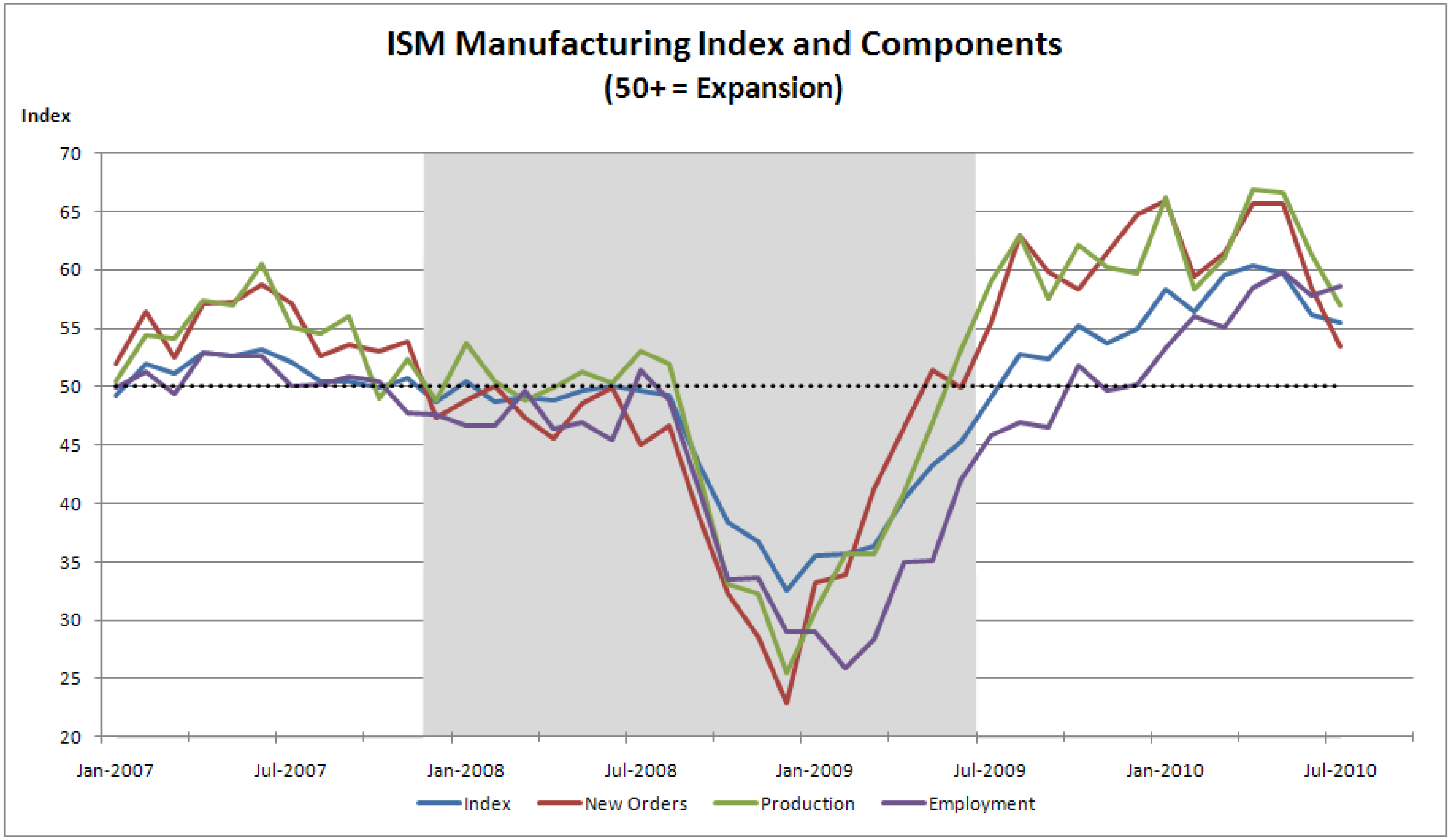


Source: Bureau of Economic Analysis. Last observation: Q2-2010.

Manufacturing continues to expand

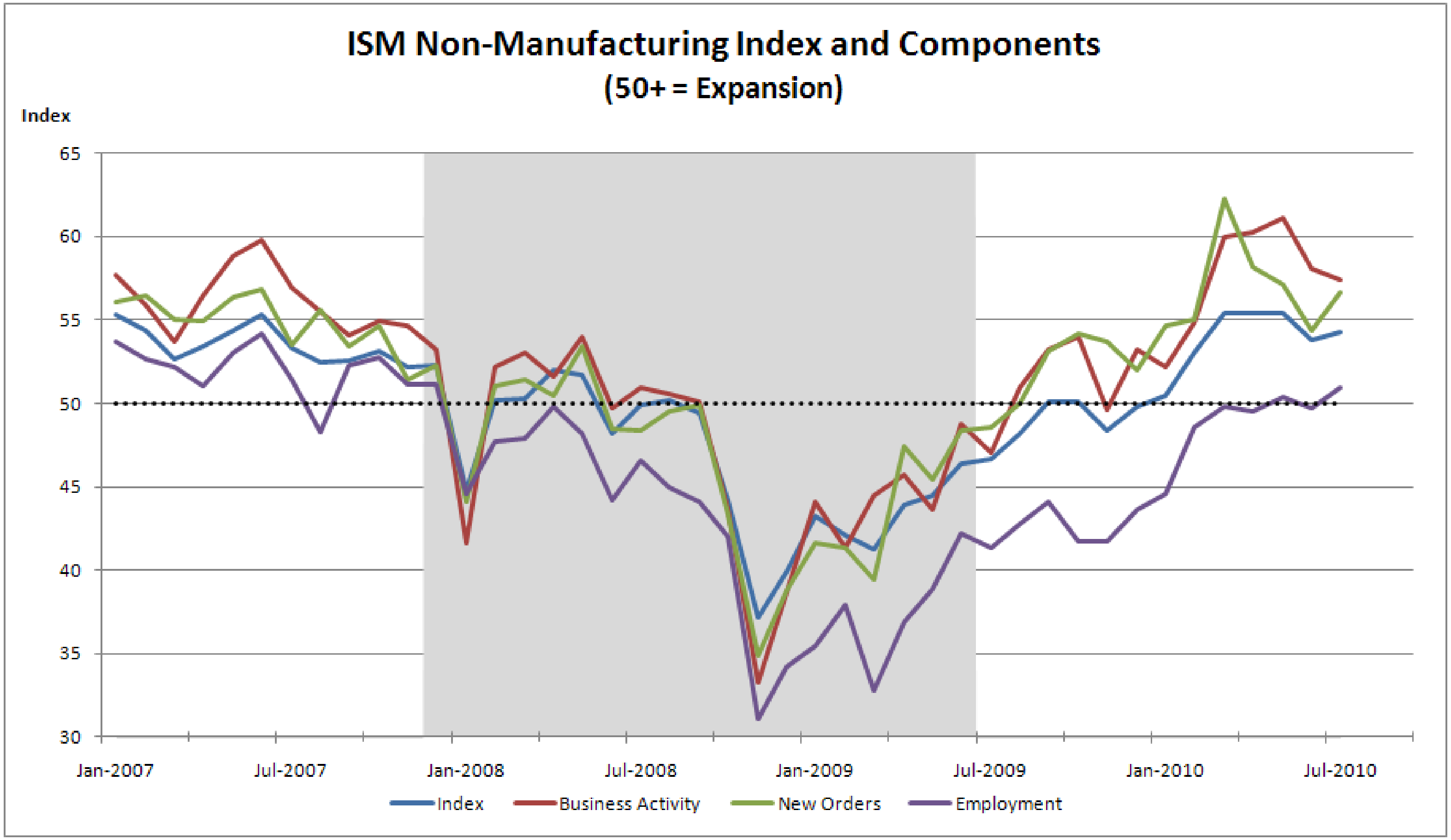
- Industrial production rose 1 percent in July.
- ISM surveys remain within the range defined as expansionary.

Manufacturing continues to expand, but at a slower pace



Source: Institute for Supply Management. Last observation: July 2010.

Non-manufacturing activity also continues to expand

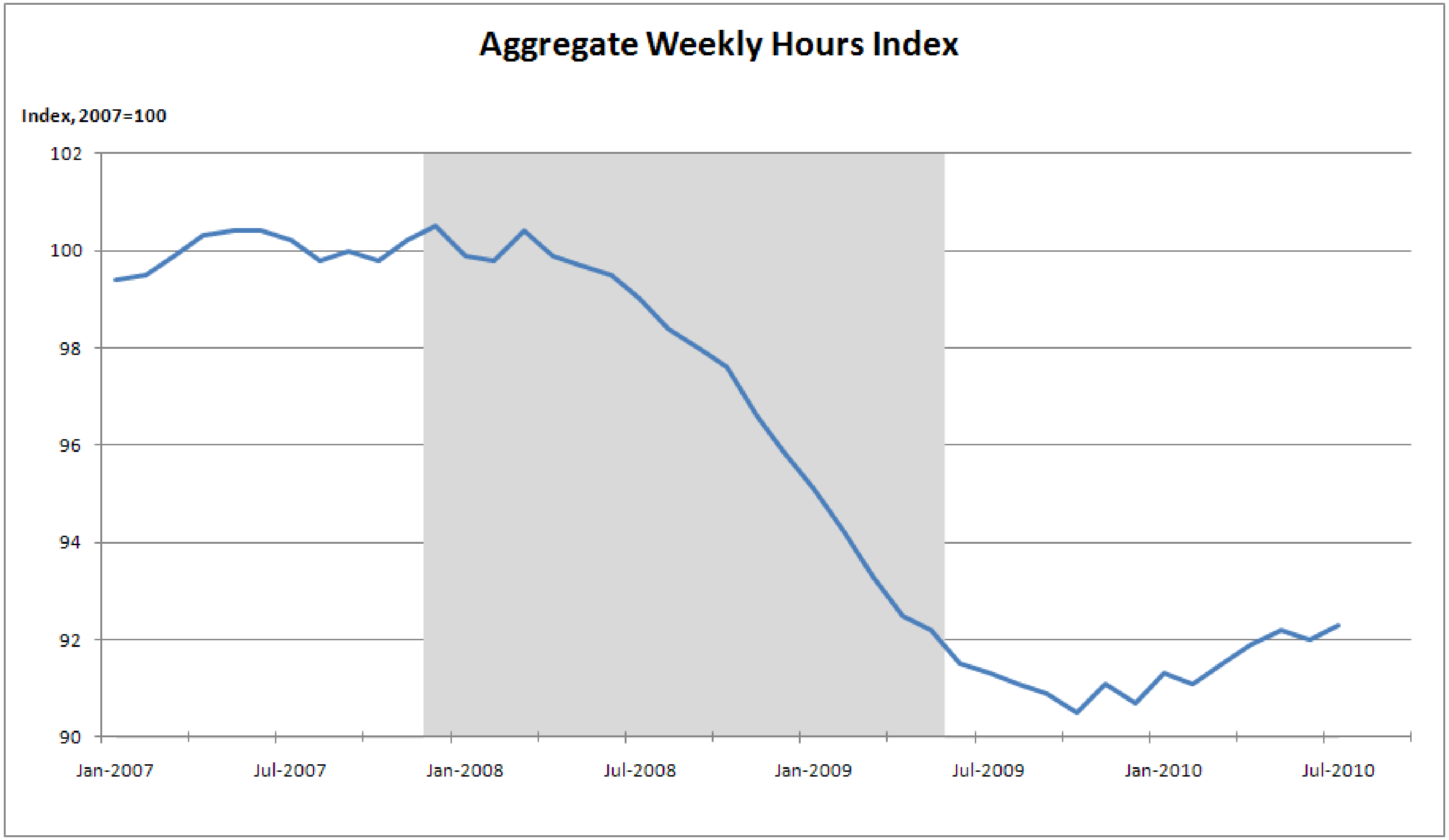


Source: Institute for Supply Management. Last observation: July 2010.

Labor markets remain weak

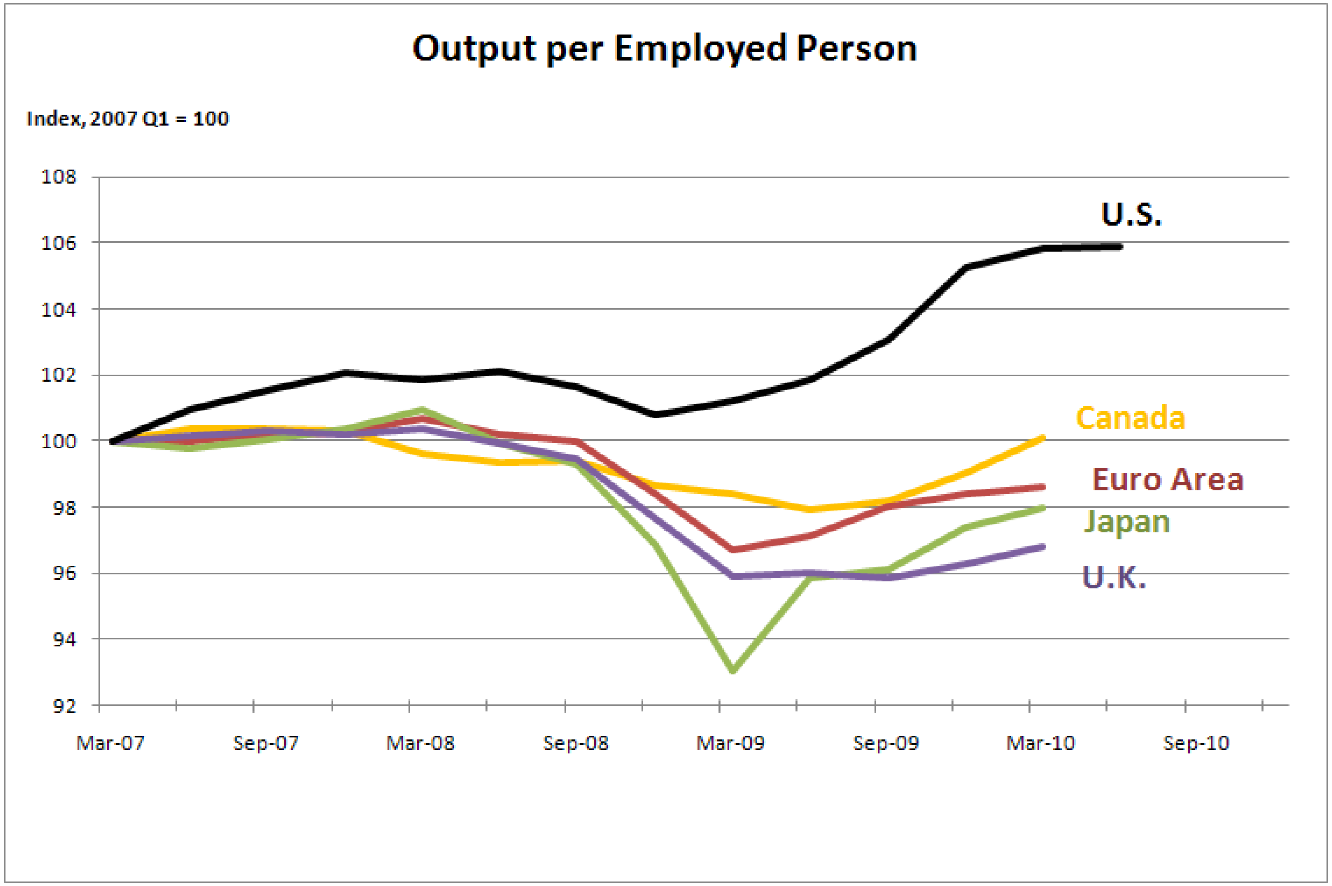
- Unemployment remains high.
- Private-sector jobs growth has been below expectations in the past three months.
- Hours worked has increased at a slow rate.
- But … U.S. productivity has improved dramatically compared with other G-7 economies.

Aggregate hours are growing slowly



Source: Bureau of Labor Statistics. Last observation: July 2010.

Productivity in the U.S. has increased since the crisis

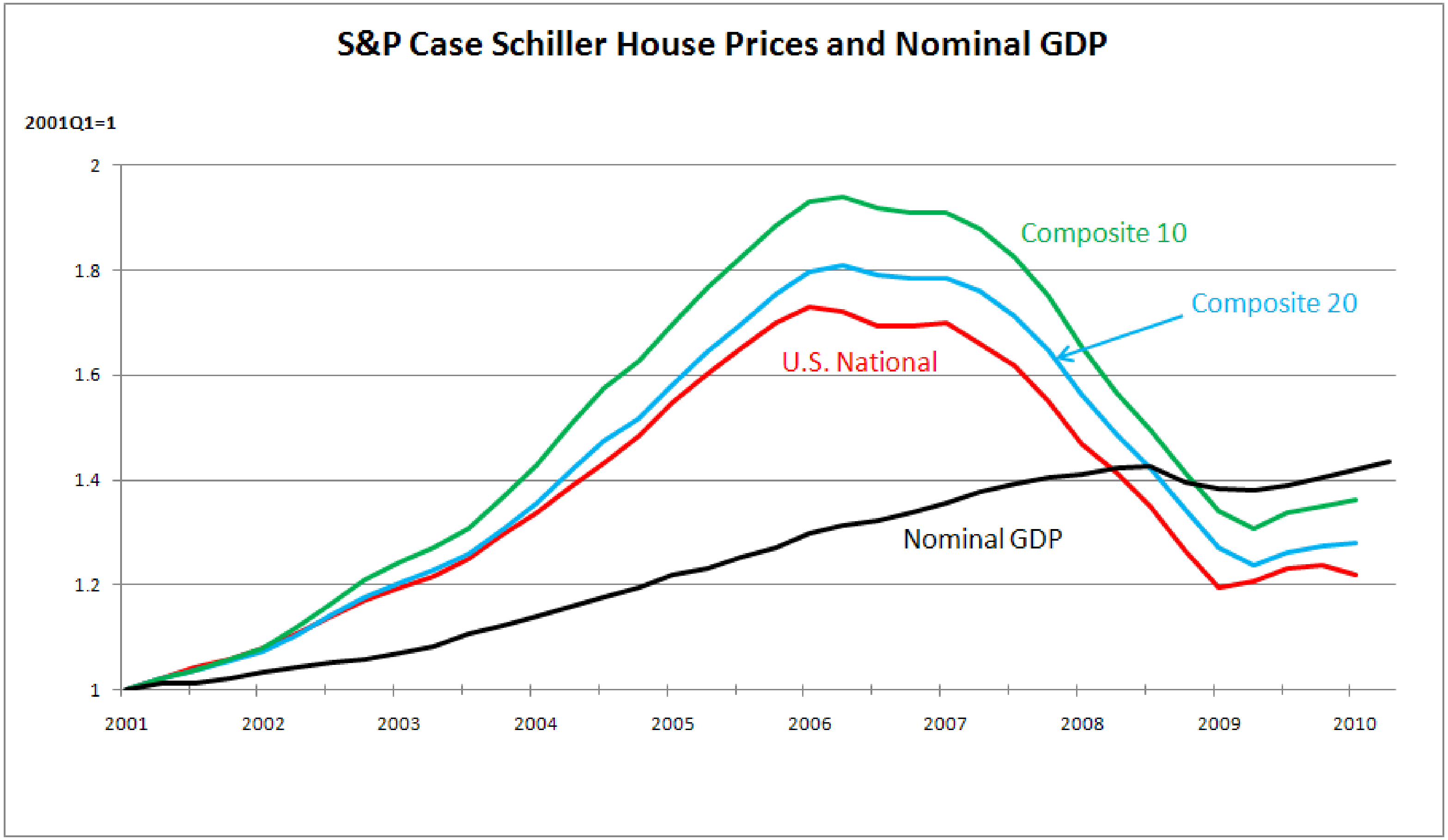


Source: Board of Governors. Last observation: Q2-2010 for the U.S. and Q1-2010 for all other countries.

Housing markets remain weak

- Home sales remain at a low level.
- Single family home construction also remains at a low level.
- Dramatic improvement seems unlikely in the near term.
- House prices remain below a 2001 nominal GDP benchmark.

House prices remain low



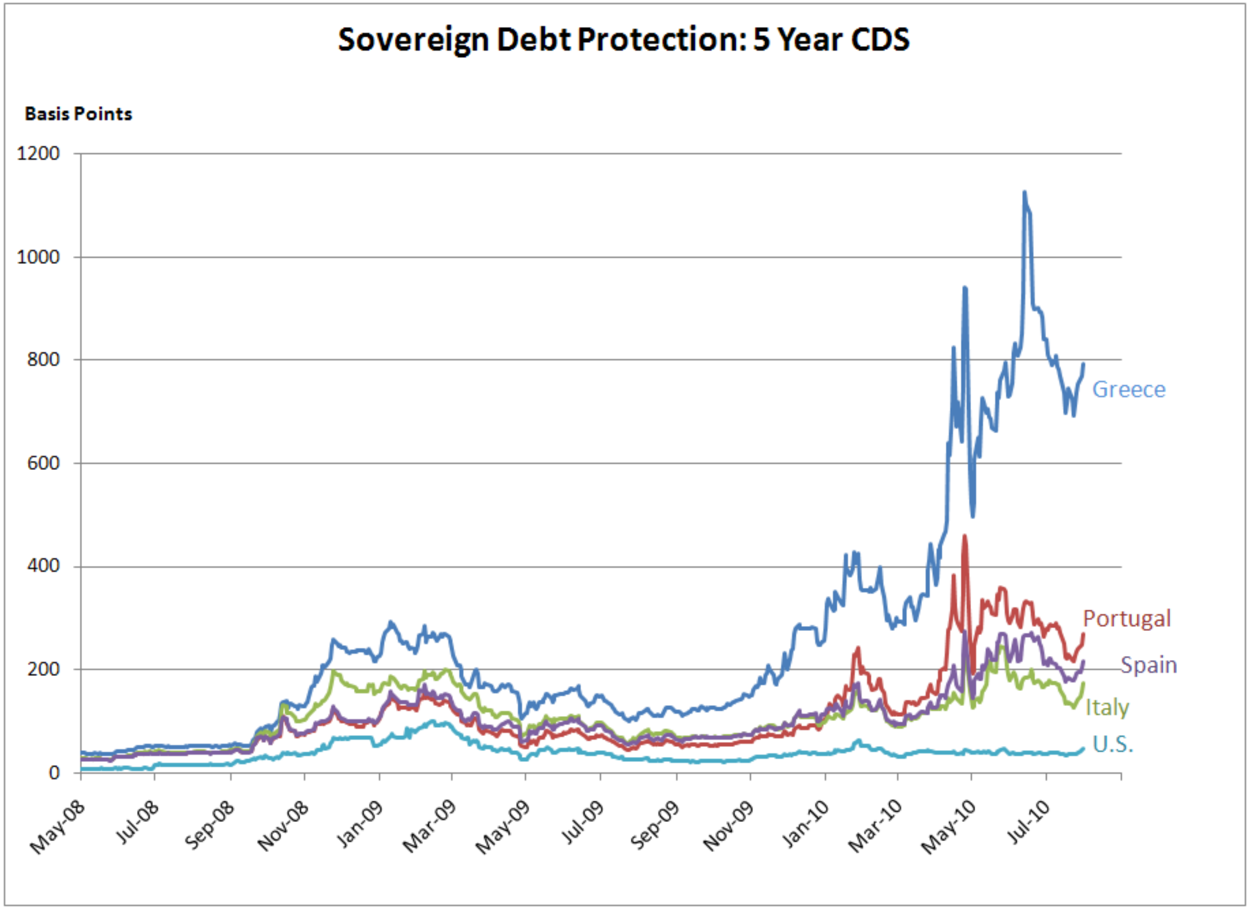
Source: S&P, Fiserv, and MacroMarkets LLC. Last observation: Q2-2010 for GDP and Q1-2010 for house prices.

The European sovereign debt crisis abates

Developments in Europe

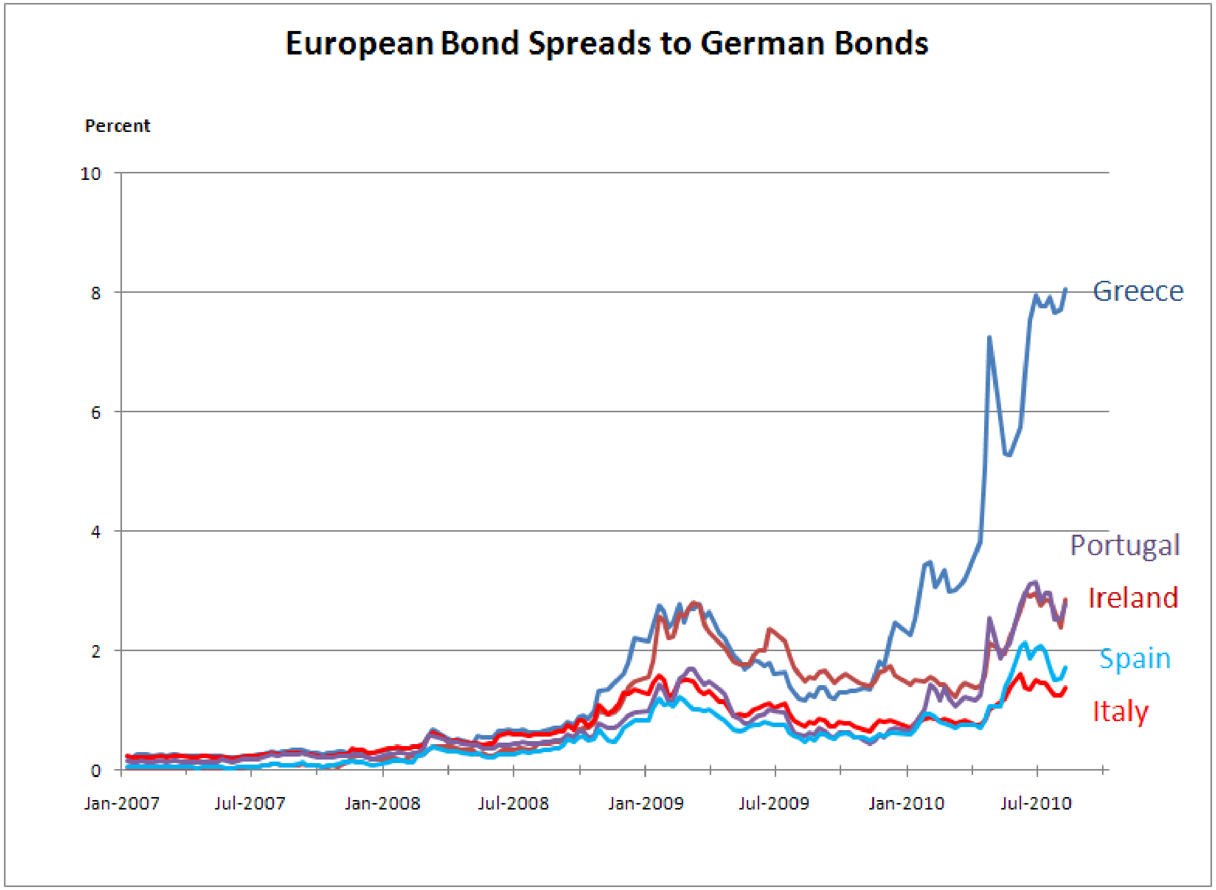
- The European sovereign debt crisis has abated somewhat, but remains an important factor in the global economic mix.
- Future developments depend on the ability of sovereign governments to deliver on fiscal retrenchment programs.
- Sensible fiscal retrenchment can improve the medium-term growth prospects for these countries.

The cost of credit insurance is high



Source: Bloomberg. Last observation: 8/12/2010, daily data.

European bond spreads remain elevated

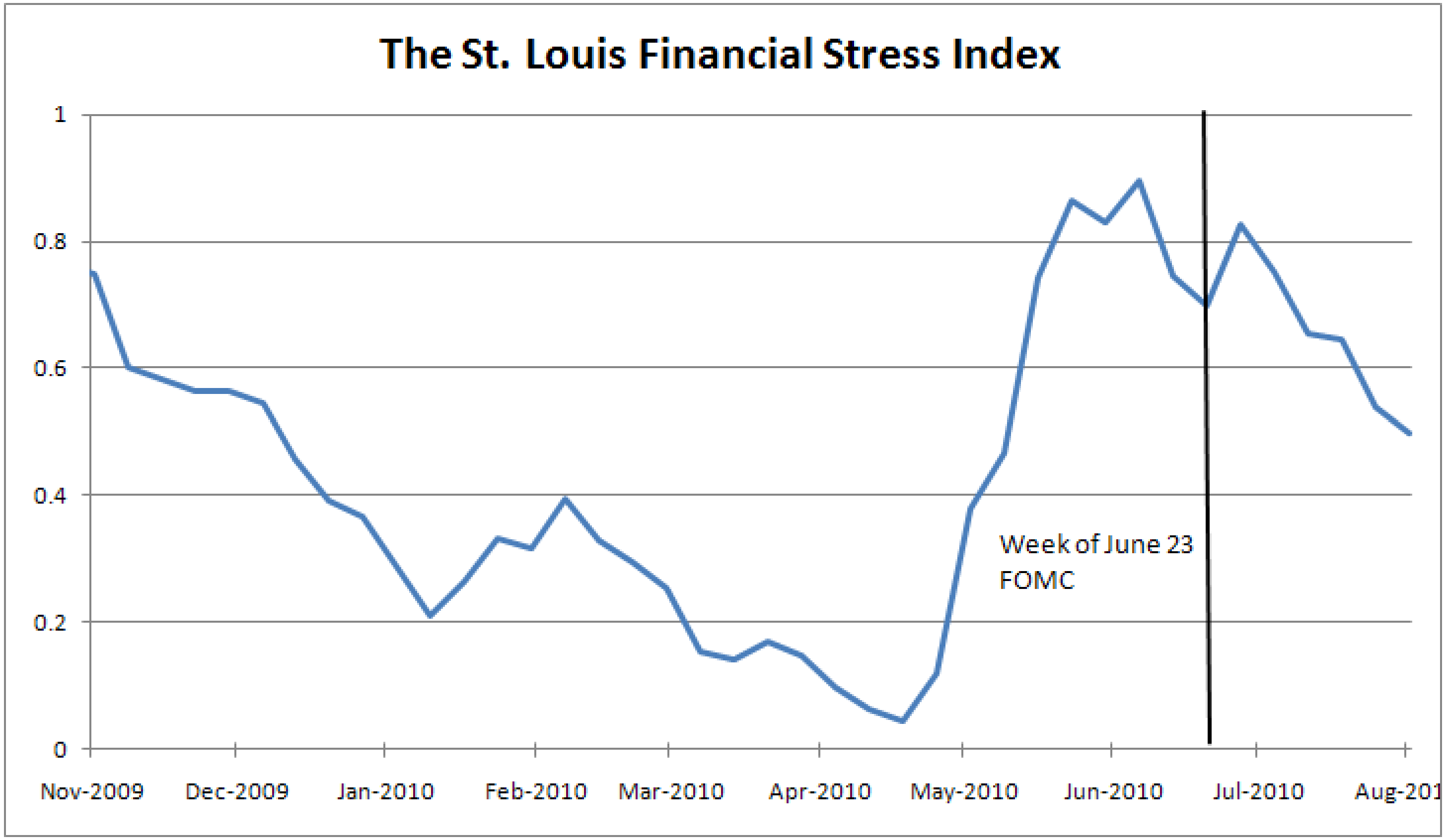


Source: Financial Times. Last observation: 8/9/2010, weekly data.

The effect on the U.S. has abated

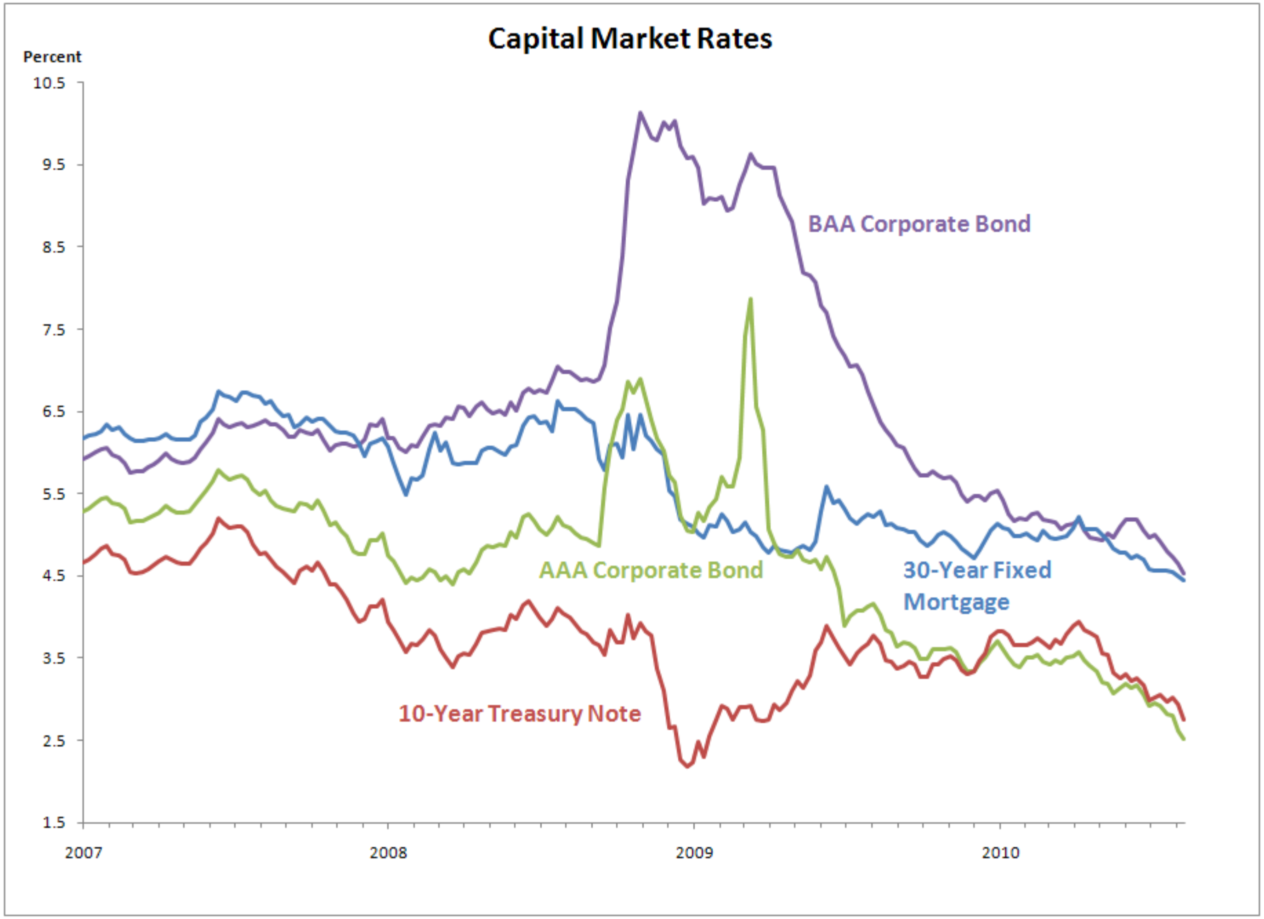
- Measures of U.S. financial stress have fallen from peak levels.
- The eurodollar exchange rate has retraced much of the euro weakness from this spring.
- Key longer-term interest rates in the U.S. are below pre-crisis levels.

Financial stress rose sharply after April 23



Source: Federal Reserve Bank of St. Louis. Last observation: 8/6/2010, weekly data.

Capital market rates are below pre-crisis levels



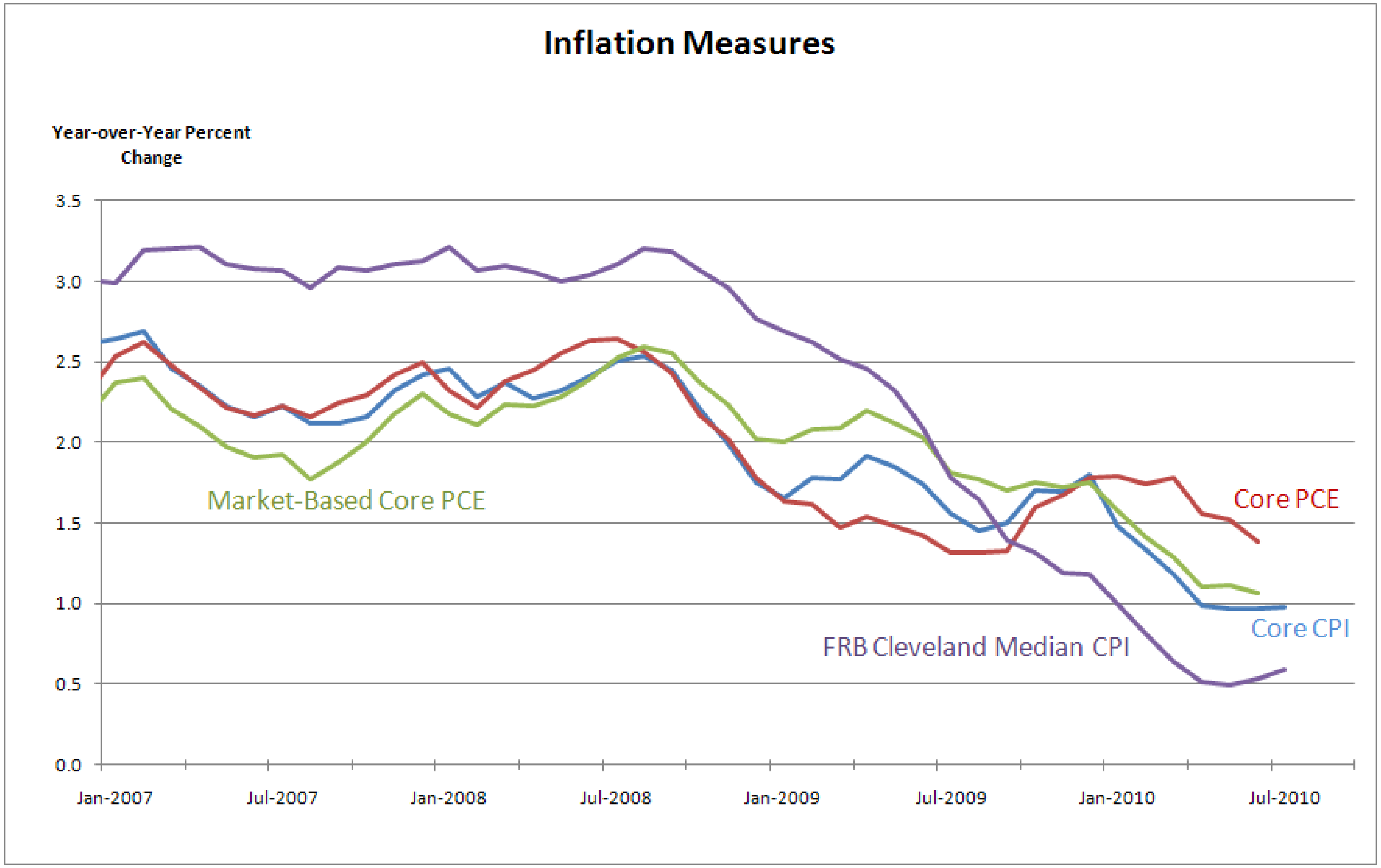
Source: Federal Reserve, Bank of America, Merrill Lynch, FHLMC. Last observation: 8/13/2010, weekly data.

Inflation developments

Disinflation during 2010

- Disinflationary trends have reasserted themselves during 2010.
- Some key measures of core inflation have fallen to about one percent.
- Inflation that is "too low" can be problematic, as the Japanese experience has shown.

Core inflation measures are low

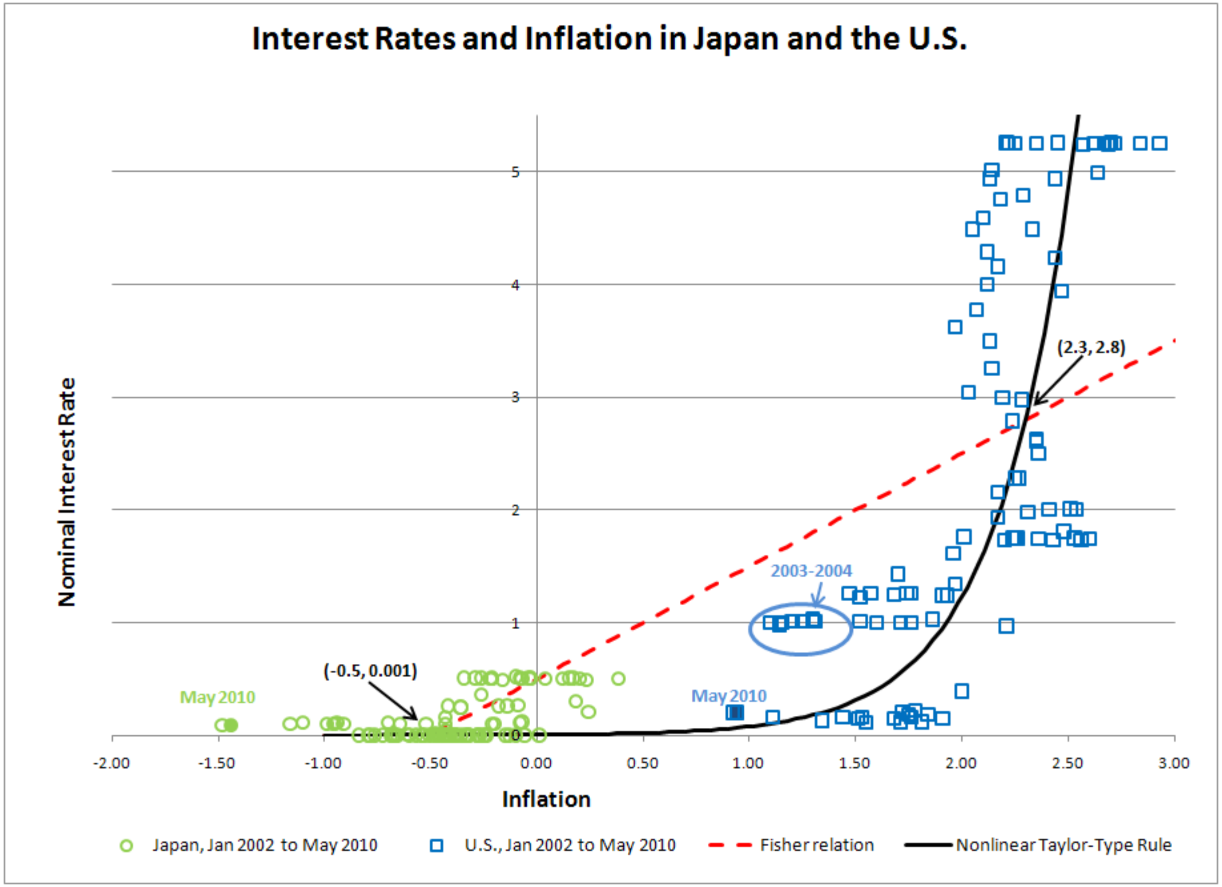


 Source: BLS, BEA, and FRB Cleveland. Last observation: June 2010 for PCE measures and July 2010 for CPI Measures.

Inflation and nominal interest rates

- Taylor-type policy rules in combination with a Fisher relation creates two possible long-run outcomes for the macroeconomy.
- Japan has been in one of these, the U.S. in the other.
- The Japanese experience has generally been regarded as disappointing.
- U.S. policy should strive to avoid this possibility.
- For more commentary, see my paper "Seven Faces of the Peril," posted on my web site.

Interest rates and inflation in Japan and the U.S.

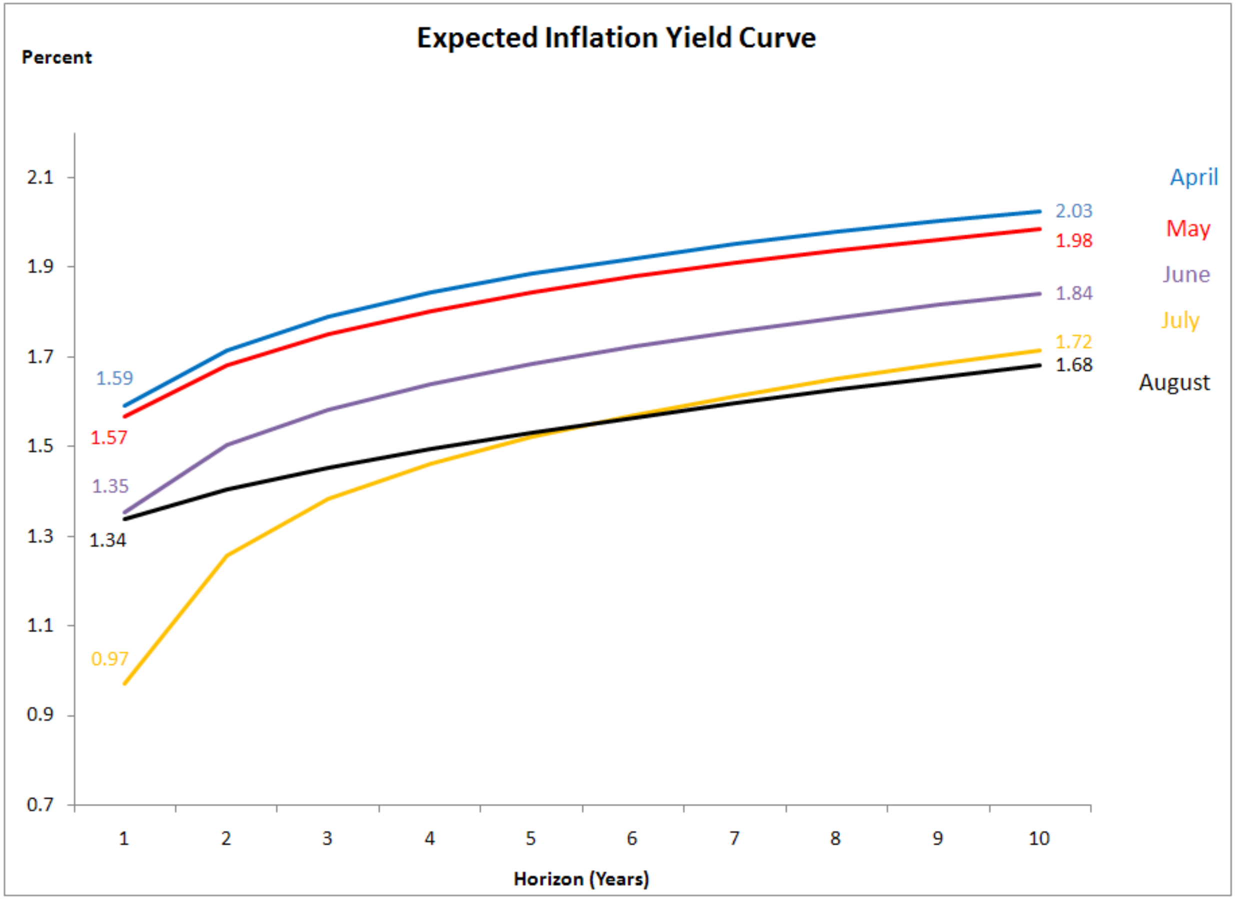


Source: OECD data and author's calculations. Last observation: May 2010.

Expected inflation

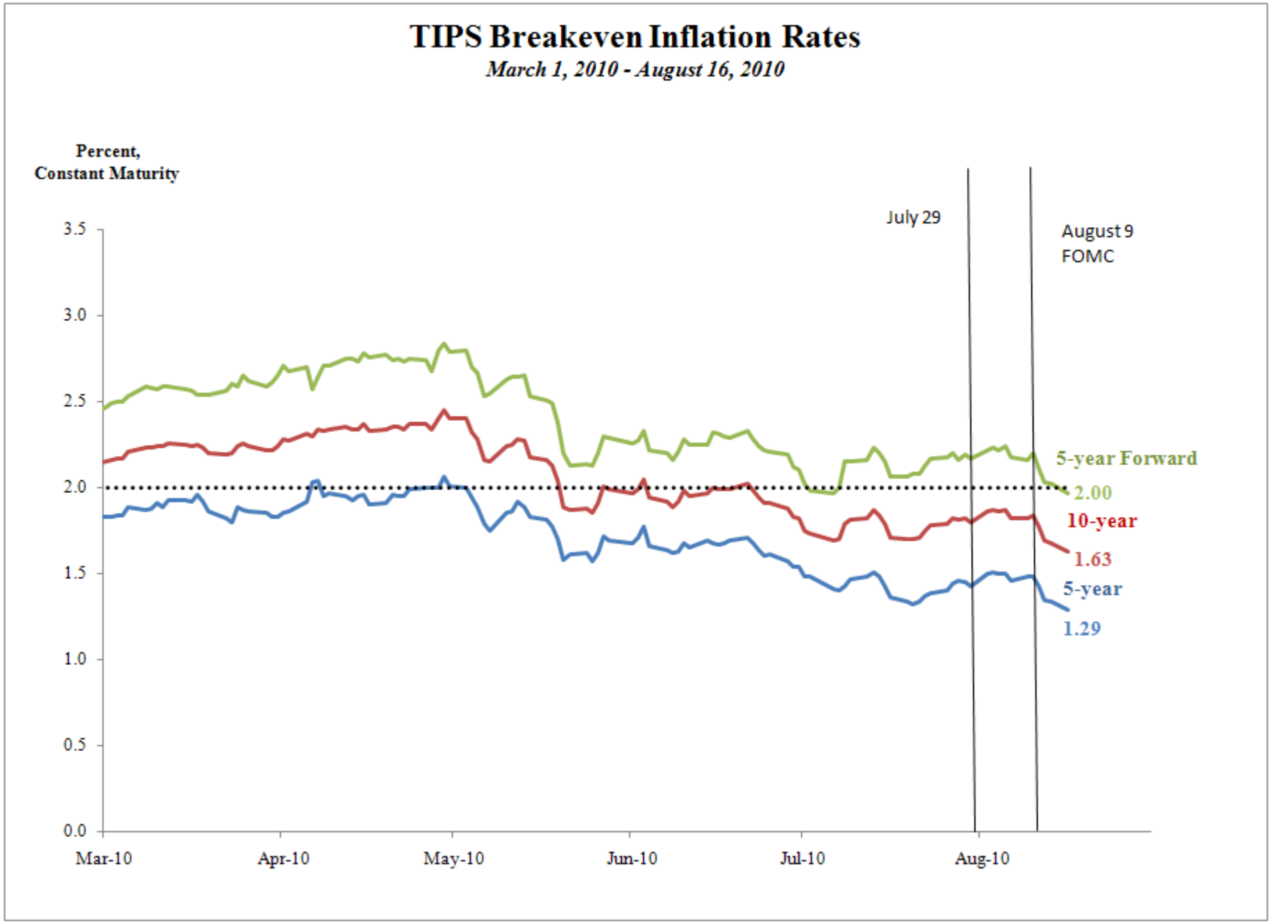
- Expected inflation at the targeted steady state is relatively high.
- Expected inflation at the unintended steady state is low or negative.
- Fortunately, expected inflation in the U.S. today, as measured from TIPS data, remains relatively high.
- However, these expectations have moved lower partly in response to the crisis in Europe.

Expected inflation has declined



Source: Federal Reserve Bank of Cleveland. Release Date: August 13, 2010.

Another look at expected inflation

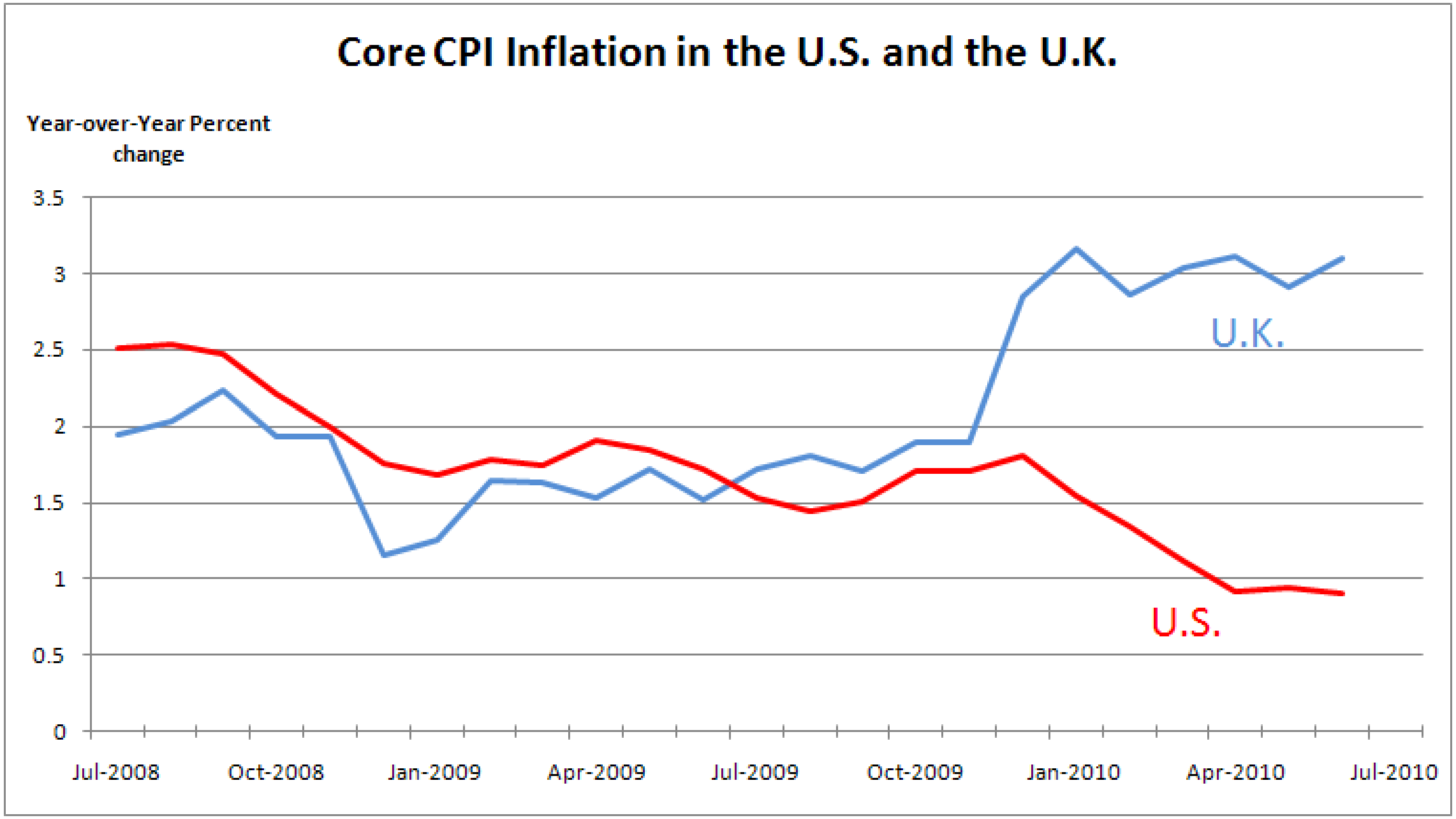


Source: Federal Reserve Board. Release Date: August 16, 2010.

The near-zero rate policy

- Keeping the policy rate near-zero may push the economy toward the targeted steady state.
- However, the policy is also consistent with the unintended steady state, where there is mild deflation.
- It may not be prudent to rely on low policy rates alone to keep the U.S. out of the deflationary outcome.
- Instead, supplement current policy with additional QE, should inflation move lower.
- The U.K. QE program can be viewed as more successful than the U.S. program for this reason.

U.S. and U.K. core inflation: opposite directions



Source: OECD. Last observation: June 2010.

What should QE look like?

Large, sudden purchases rarely are optimal

- "Shock and awe" is almost never a good way to proceed.
- Instead, policy actions should be commensurate with the risks that the economy faces.
- A series of smaller policy actions can add up to a large action, but only if incoming data suggest that as the appropriate course.
- Example: 25-basis-point interest rate moves are relatively small by themselves, but can have large effects as part of a policy path for interest rates.

A disciplined program

- Today, with core inflation at low but manageable levels and the economy expected to continue to expand, no action is necessary.
- Should economic developments suggest increased disinflation risk, purchases of Treasury securities in excess of those required to keep the size of the balance sheet constant may be warranted.
- Purchase size should be in proportion to the size of any deterioration in the outlook.
- One key goal of the program is to keep core inflation in the U.S. from falling close to levels observed in Japan.

Conclusions

- The U.S. outlook has been downgraded, but still remains positive—continued expansion is the most likely course going forward.
- The European sovereign debt crisis has abated somewhat, but remains a factor in the global economic mix.
- Core inflation has fallen to low, but still manageable, levels. If the risk of further disinflation builds, Fed action may be warranted.
- Any QE actions should be disciplined and focused.

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