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The U.S. Economic Situation and Recent Monetary Policy Developments

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The FOMC decision

- The FOMC voted to pursue “QE2” last month.
- Even before this action, monetary policy was ultra-easy:
 - The policy rate is near zero for an “extended period.”
 - The Fed’s balance sheet is much larger than it was pre-crisis.
- After the November meeting, the Committee stated that:
 - The Fed will purchase Treasury securities at a pace of about \$75 billion per month through the first half of 2011.
 - The Committee will regularly review the program.

Regular review of the program

- I think that the regular review clause is important.
- When the FOMC targets interest rates, a typical move is 25 basis points, and forward guidance is limited.
- This allows the Committee to adjust the policy rate in response to a changing outlook for the economy.
- The regular review clause allows the QE program to be adjusted in response to incoming data in the same way.

My view of the FOMC decision

- I will give a five-part description of this decision:
 - 1) There has been a disinflationary trend in 2010.
 - 2) Japanese experience indicates that a near-zero nominal interest rate, mildly deflationary equilibrium exists and is difficult to escape.
 - 3) Monetary policy should be directed to avoiding this outcome, but U.S. short-term interest rates are already approximately zero.
 - 4) Asset purchases can substitute for ordinary monetary policy, and have had conventional financial market effects.
 - 5) Maximum effects on the real economy take 6 to 12 months and can be difficult to disentangle, but should be conventional as well.

Risks and rewards

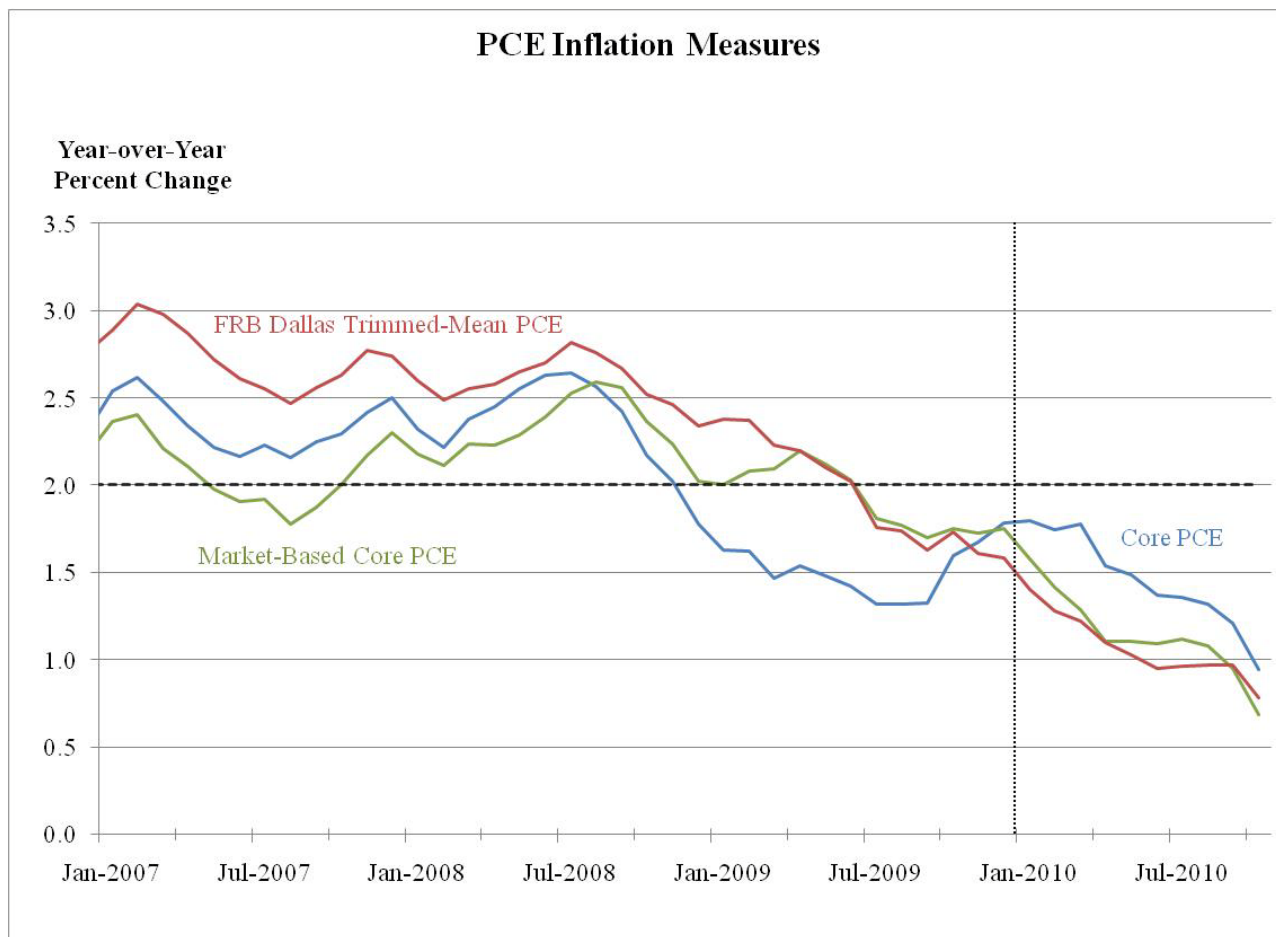
- The new policy carries some risks.
- I will discuss some of the risks in the second part of the talk.
- I think the benefits outweigh the risks, but the risks are very real.
- I will turn to a variety of related topics later in the talk.
- Let's get started.

1. Disinflation

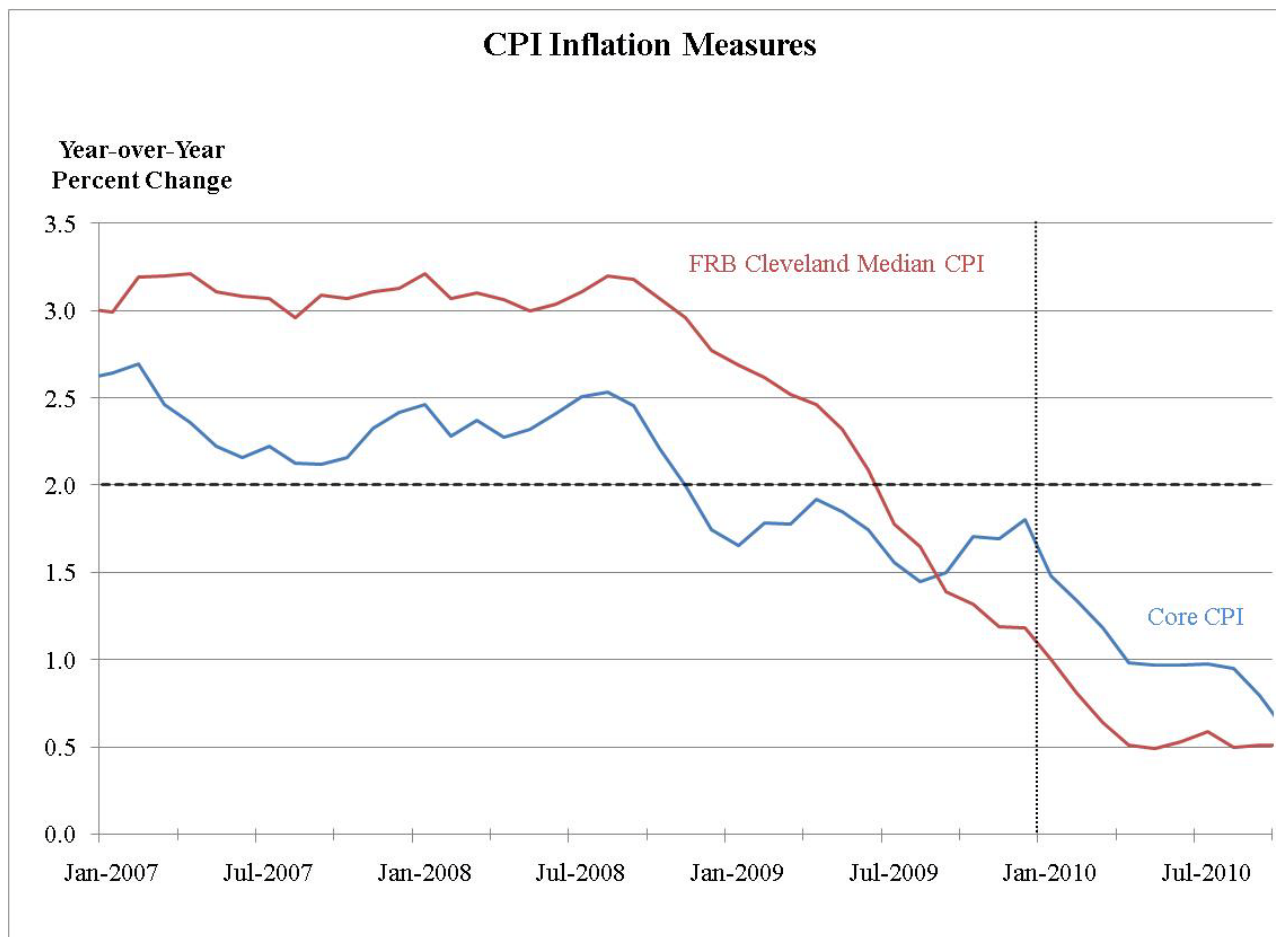
A disinflation trend in 2010

- Inflation was close to the implicit FOMC inflation target during the first part of 2010.
- During 2010, a clear disinflation trend developed.

Disinflation trend in 2010, PCE



Disinflation trend in 2010, CPI

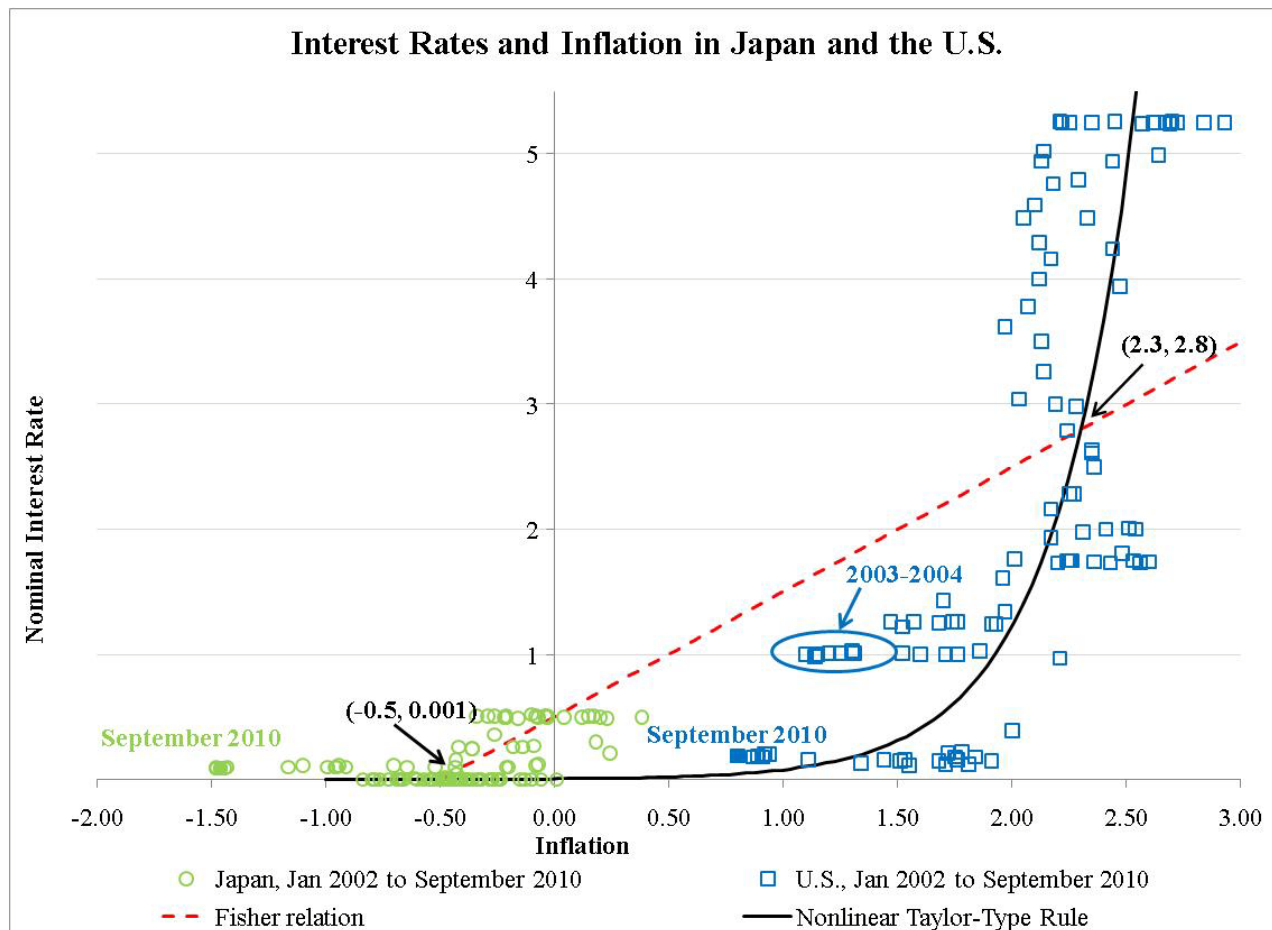


2. Lessons from Japan

Inflation and nominal interest rates

- Taylor-type policy rules in combination with a Fisher relation create 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.



The near-zero interest rate policy

- It may not be prudent to rely on a near-zero policy rate alone to keep the U.S. out of the deflationary outcome.
- It is true that near-zero rates 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.
- Instead of relying on low rates alone, supplement current interest rate policy with additional QE.

3. Policy Strategy

Policy question

- What to do given (1) a slower recovery with a disinflationary trend, and (2) knowledge of what happened in Japan?

Policy strategy

- First, avoid further disinflation.
 - Further disinflation with short-term nominal interest rates at zero would mean rising real interest rates in the face of a slowing pace of recovery.
- Second, pre-empt the unintended steady state.
 - It would be difficult to escape the low nominal interest rate, mildly deflationary equilibrium that Japan has experienced.
- Third, defend the implicit inflation target from the low side.
 - This helps maintain longer-run inflation expectations.

4. Asset Purchases

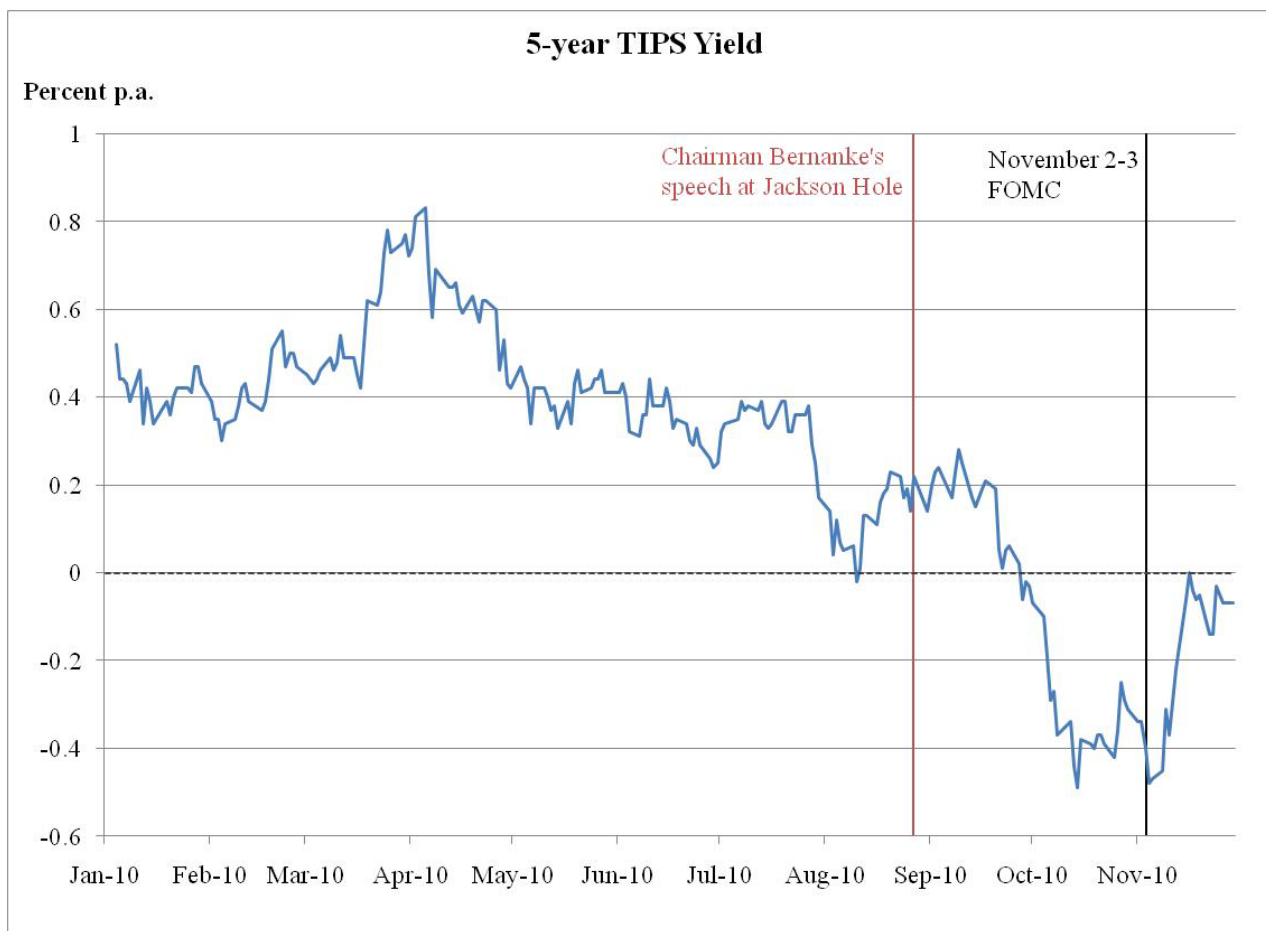
Implementation via asset purchases

- Ordinary monetary policy would lower short-term nominal interest rates, but those rates are already near zero.
- Asset purchases of Treasury securities at longer maturities can substitute for ordinary monetary policy.
- This puts downward pressure on nominal interest rates further out the yield curve, along with upward pressure on expected inflation.
- Accordingly, the policy puts downward pressure on real interest rates.

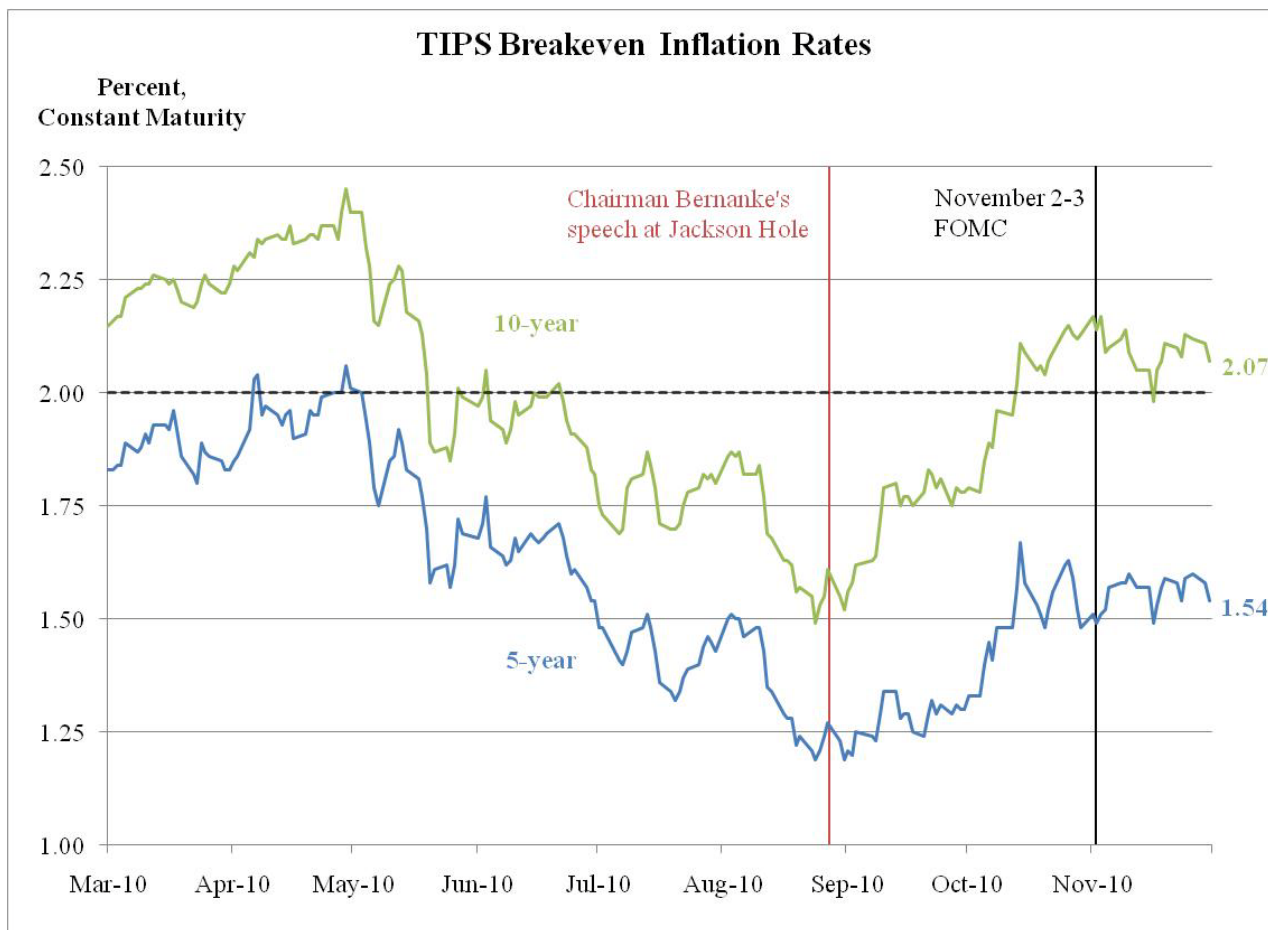
The effects of asset purchases in financial markets

- The policy change was largely priced into markets ahead of the November FOMC meeting.
- While asset purchases are sometimes viewed as unconventional, the financial market effects have been entirely conventional.
- In particular, real interest rates declined, inflation expectations rose, the dollar depreciated, and equity prices rose.
- These are the same financial market effects one might observe when the Fed eases monetary policy in ordinary times (that is, in an interest rate targeting environment).

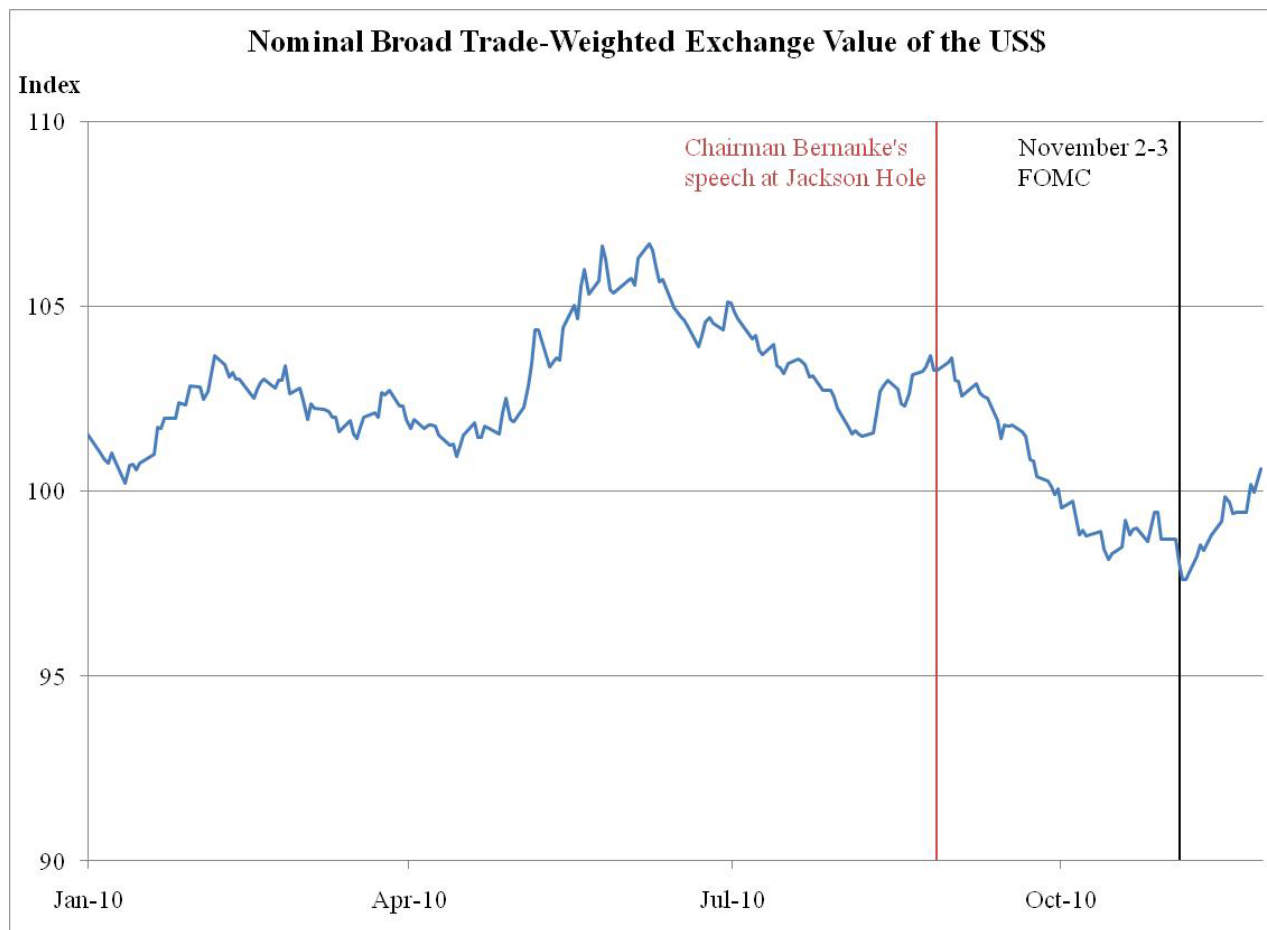
Real interest rates declined



Expected inflation increased



The dollar depreciated



Equity prices increased



The effects of asset purchases in financial markets

- Again, the policy change was largely priced into markets ahead of the November FOMC meeting.
- The financial market effects during this period were entirely conventional.
- Financial market effects spill into the real economy with a lag.

5. Effects on the Real Economy

The effects on the real economy

- What about the effects on the real economy?
- An easing of monetary policy produces its maximum impact on real variables in the economy, including output, consumption, and investment, with a lag of 6 to 12 months.
- Economic performance will be influenced by other developments during this period, so it will be difficult to disentangle the real effects of the policy action from other influences on the economy.
- However, this is a standard problem in discerning the real effects of monetary policy.
- Most likely, the real effects will be just as conventional as the financial market effects.

Risks and Criticisms

Risks and criticisms: “The program will not work.”

- Many have argued that asset purchases would not be effective.
- I have argued that the financial market effects of the program have been about what one would expect from an easing of monetary policy.
- The real effects will likely peak with a lag of 6 to 12 months, but will be hard to disentangle from other factors.

Risks and criticisms: “This depreciates the dollar.”

- Dollar depreciation is a normal by-product of an easier monetary policy, provided all else is held constant in the rest of the world.
- The U.S. has long maintained an independent monetary policy, a flexible exchange rate, and open capital markets.
- Other countries have to have systems in place that can adjust to modest changes in U.S. monetary policy.

Risks and criticisms: “Nominal rates have risen.”

- QE2 puts downward pressure on nominal rates through securities purchases.
- But, successful policy would:
 - Generate somewhat faster economic growth and somewhat higher real interest rates,
 - Generate somewhat higher inflation expectations.
- Both of these effects put upward pressure on nominal rates.
- Therefore, looking at the level of nominal rates alone is insufficient to judge the success of the program.

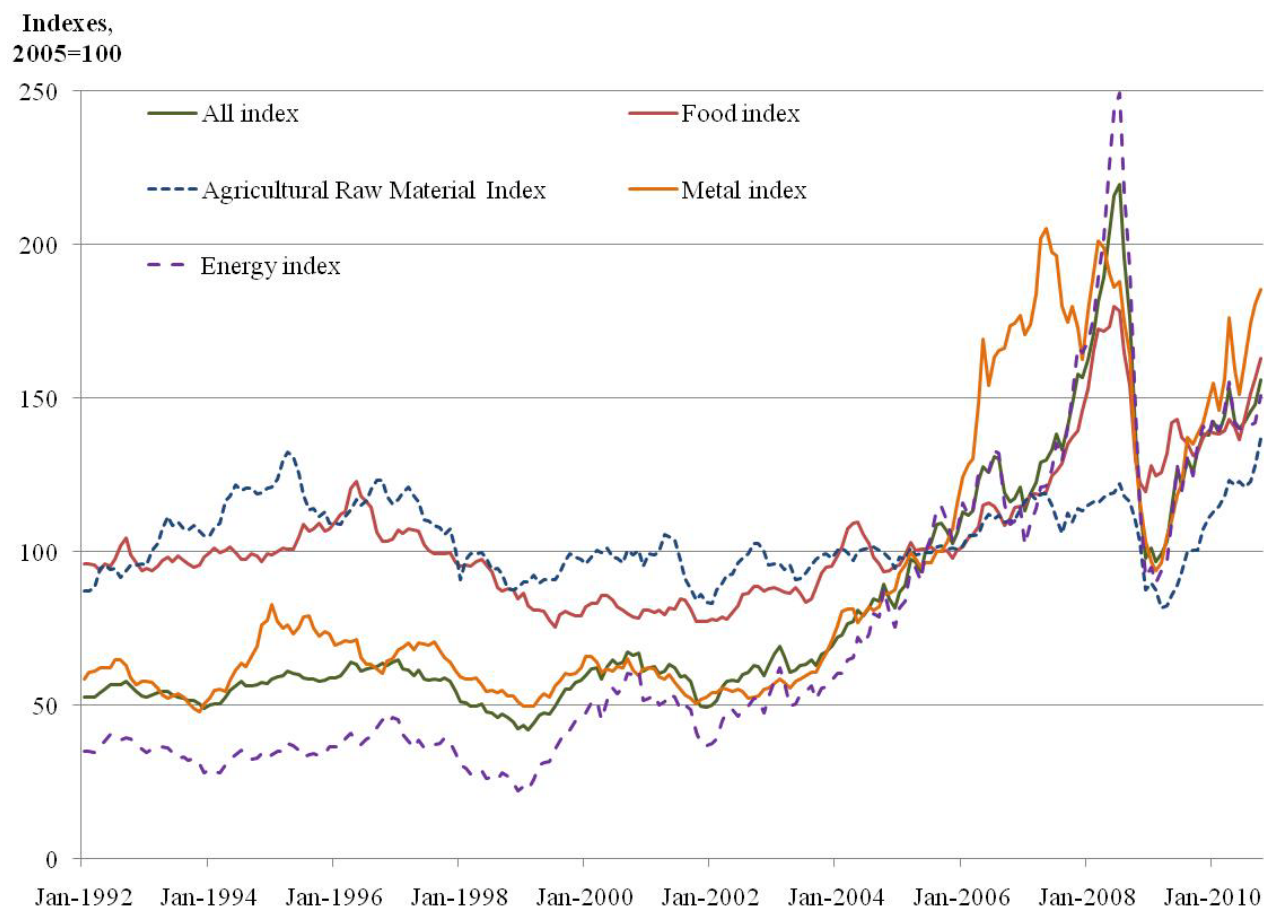
Risks and criticisms: “This is a replay of the 1970s.”

- My monetarist friends are anxious to avoid creating too much inflation.
- This is a legitimate and important concern.
- If inflation were to rise too high, the Committee might lose its hard-earned credibility for maintaining low and stable inflation.
- I have argued that the 2010 disinflationary trend is worrisome right now.
- I completely agree that keeping inflation near the Committee's implicit inflation target is very important for maintaining credibility.

Risks and criticisms: “Use a commodity standard.”

- There is a long and venerable tradition of commodity money standards.
- This was last widely discussed in the U.S. during the 1970s and 1980s, when inflation was high and variable.
- The volatility of commodity prices in recent years has made the commodity standard approach problematic.
- But inflation targeting can be seen as the intellectual descendant of commodity money standards.
- Inflation targeting forces accountability for inflation outcomes onto the central bank.

Indexes of commodity prices



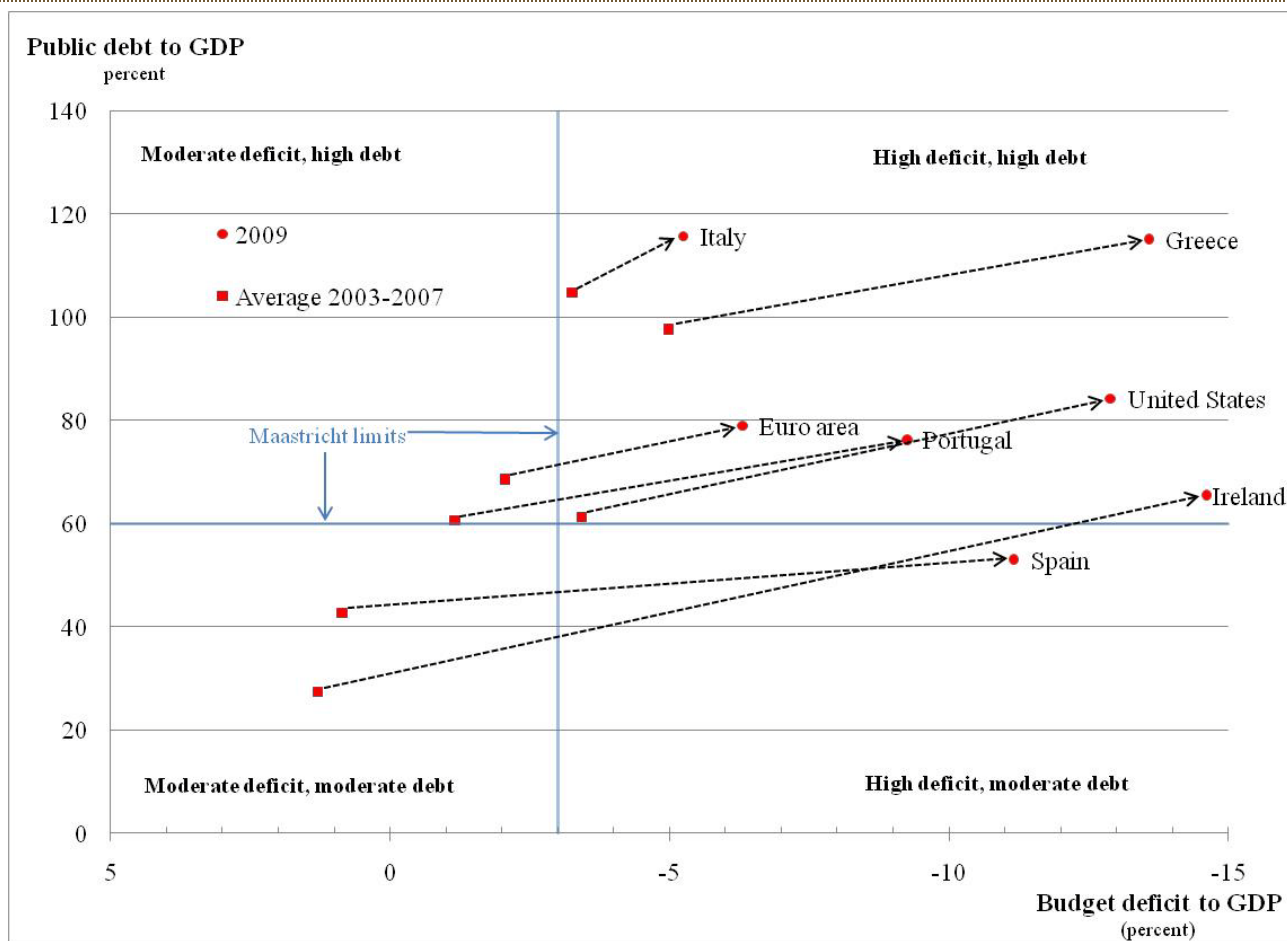
Risks and criticisms: “The Fed is monetizing the debt.”

- The Committee has often stated its intention to return the Fed balance sheet to normal, pre-crisis levels over time.
- Once that occurs, the Treasury will be left with just as much debt held by the public as before the Fed took any of these actions.

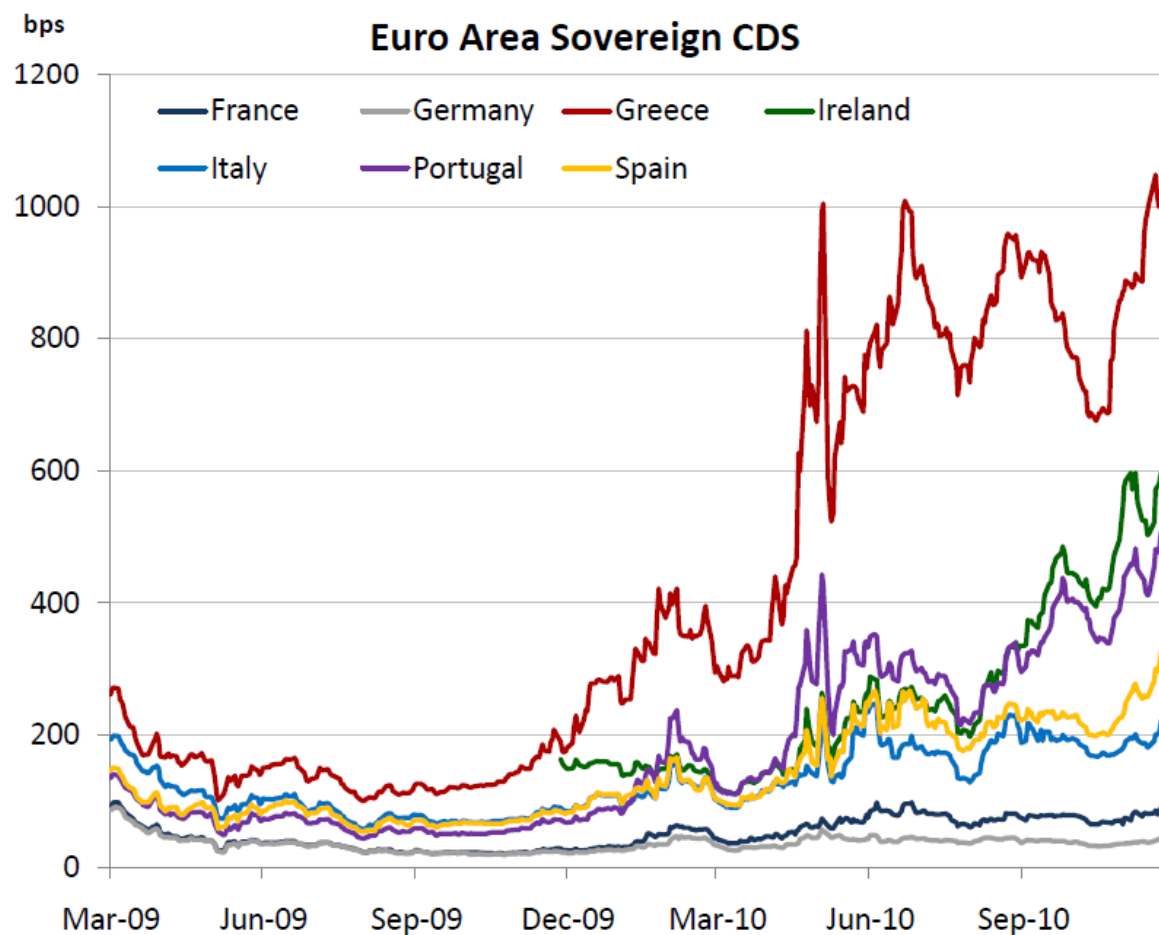
Risks and criticisms: “QE mitigates fiscal problems.”

- QE has no impact on the longer-run fiscal outlook for the U.S.
- This outlook remains very poor no matter what the Fed does.
- It is absolutely imperative that the Congress and the President attack the long-run budget problems the nation faces.
- Europe has given the U.S. an important wake-up call on how devastating it can be to leave long-run structural deficit problems unaddressed.

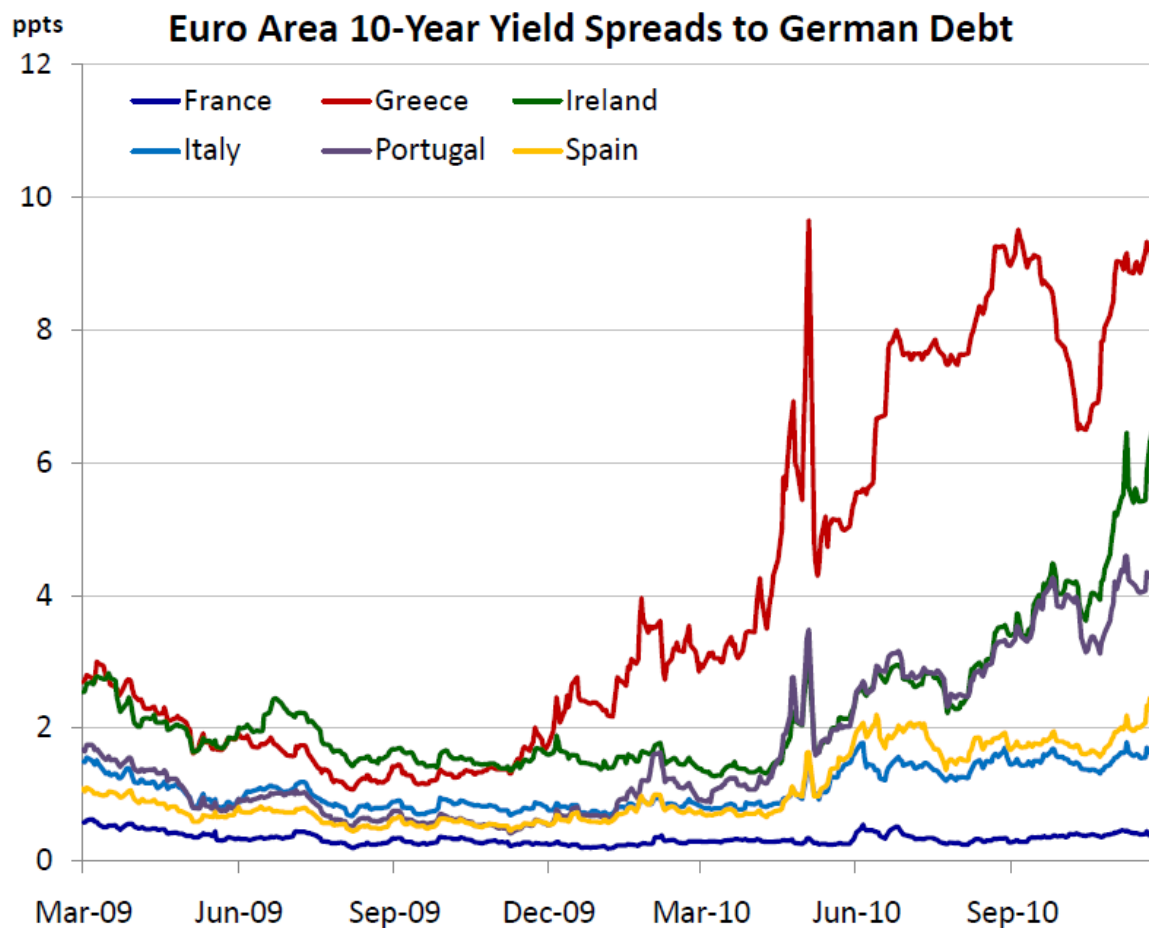
Fiscal indicators for selected countries



Euro area sovereign CDS's



Euro area 10-year bond spreads



Conclusion

Conclusion

- I have outlined my perspective on the recent FOMC decision to pursue additional asset purchases.
- My view puts weight on the idea that the 2010 disinflationary trend is a concern.
- The QE program does nothing to change the longer-term fiscal outlook for the U.S.
- The longer-term fiscal problems for the U.S. remain daunting and must be confronted.



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