U.S. Monetary Policy at Another Crossroads

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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.

A weaker-than-expected recovery

- The U.S. economy is growing only sluggishly, and the FOMC has warned about "substantial downside risks."
- Should economic performance deteriorate, monetary policy will respond.
- The Fed has potent tools at its disposal and is not now, or ever, "out of ammunition."
- The main question remains how to conduct an effective, systematic, countercyclical monetary policy when nominal interest rates are near zero.
- I will offer some suggestions for monetary policy going forward.

Three guidelines for medium-term monetary policy

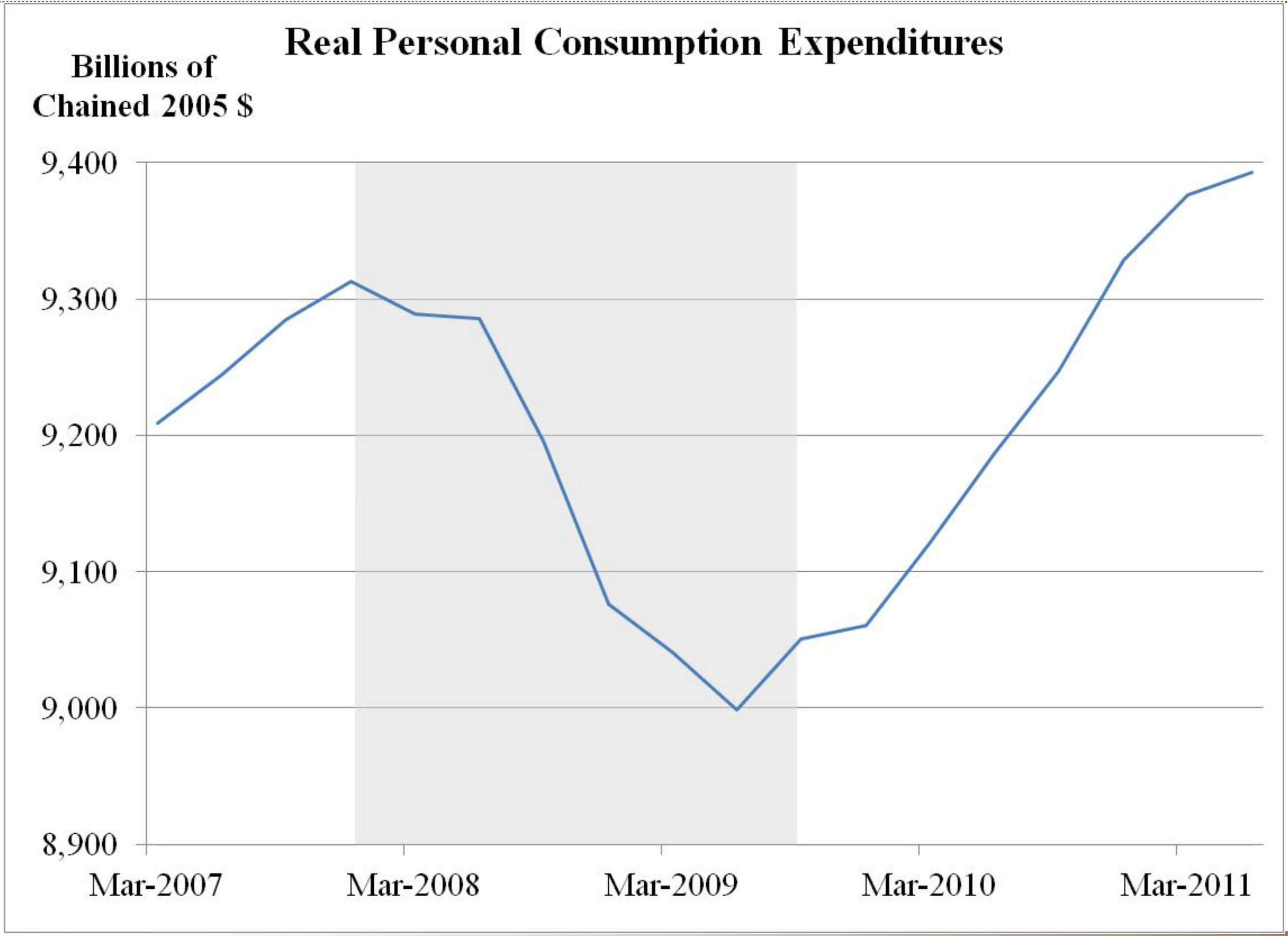
- Embrace rule-like behavior.
- Transmit policy through inflation and expected inflation, as opposed to nominal interest rates.
- Keep a keen awareness of the Japanese example.
  - Relying solely on promises of low policy rates for longer and longer periods of time may simply be a path to the Japanese outcome.

Sluggish Economic Growth

America's investment problem

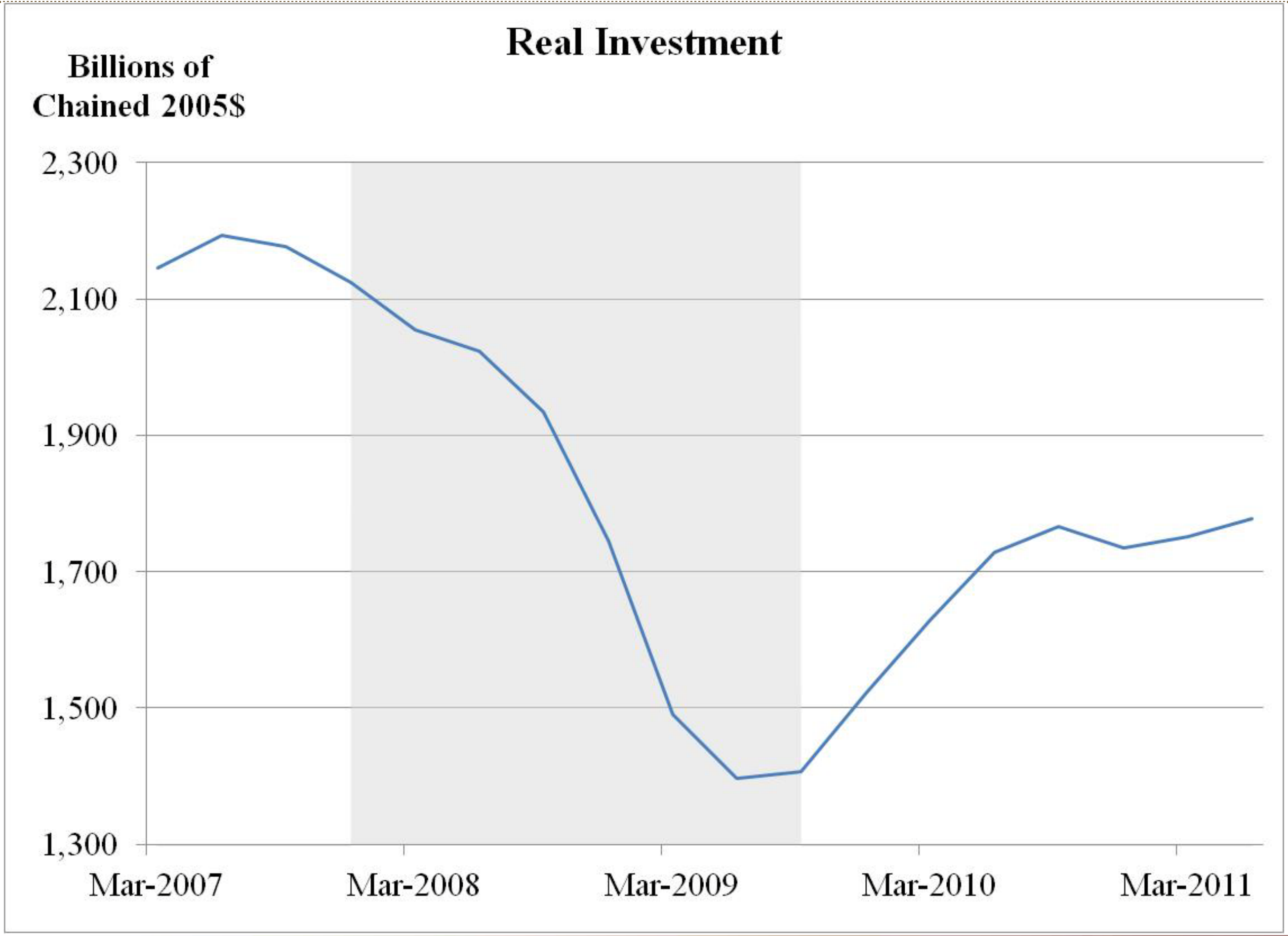
- The pace of economic recovery during 2011 has been disappointing.
- Most components of real GDP have recovered to or beyond their 2007 Q4 peak.
- Aggregate real household consumption, for instance, is higher today than at any time in U.S. postwar history.
- However, investment is still off the 2007 Q4 peak by about 16 percent.
- Much of this is due to weakness in residential investment and investment in nonresidential structures.

Real consumption: recovered



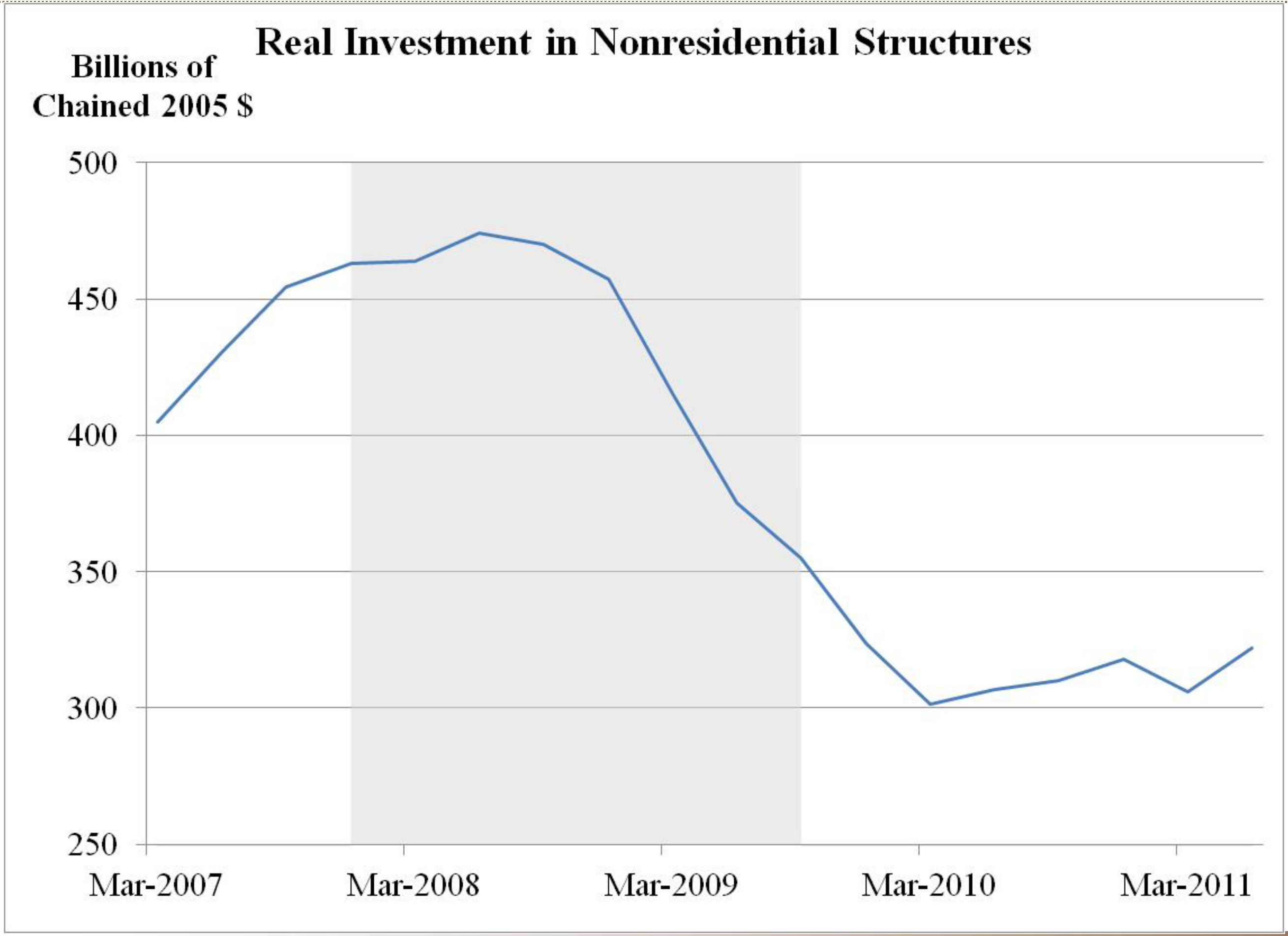
Source: Bureau of Economic Analysis. Last observation: 2011-Q2.

Real investment: still down 16 percent



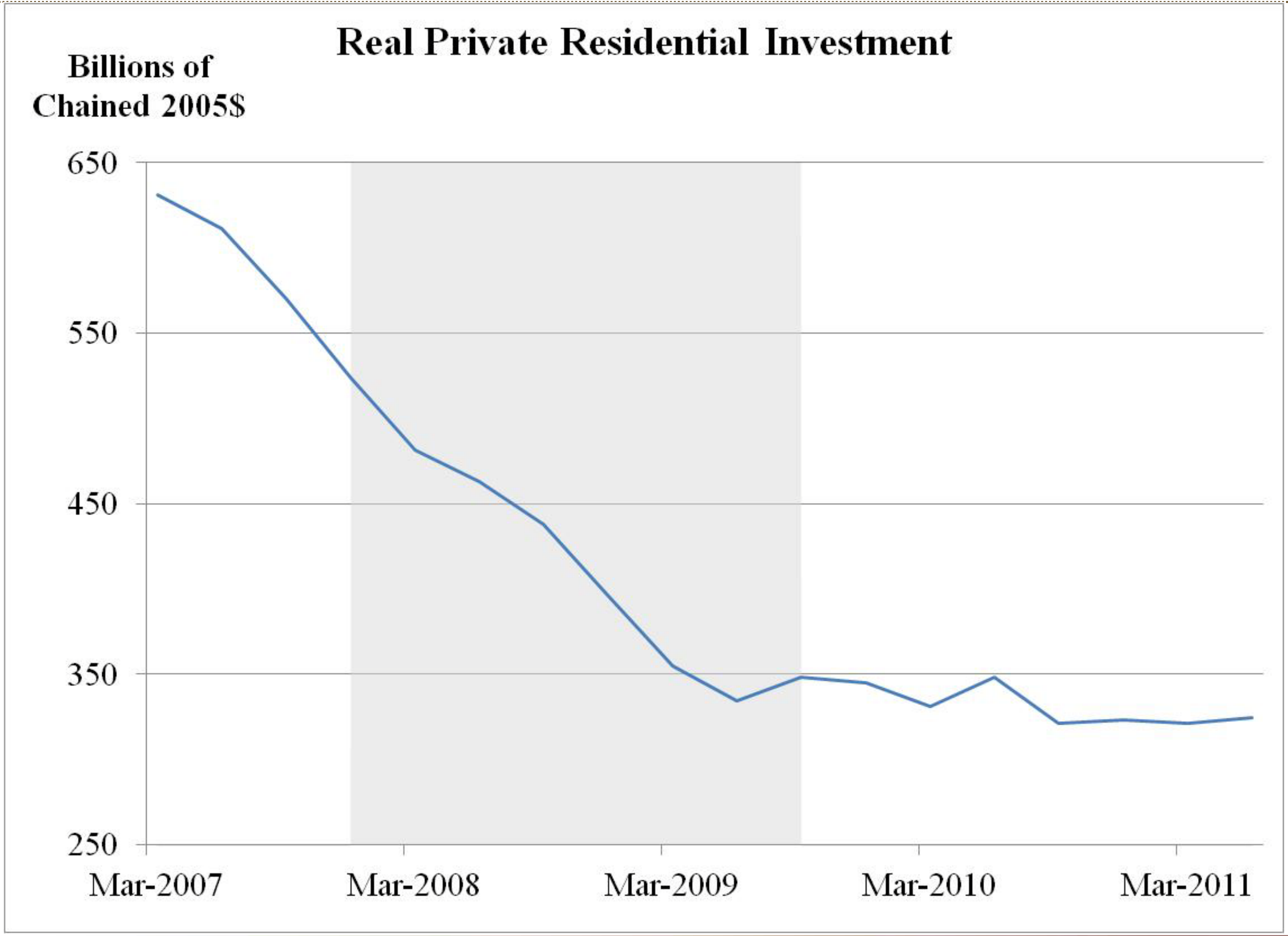
Source: Bureau of Economic Analysis. Last observation: 2011-Q2.

Real investment in nonresidential structures



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

Real residential investment



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

A bubble has collapsed

- This looks like a collapsed real estate bubble.
- If the investment component of GDP had recovered to the extent that consumption has recovered, GDP would be higher by 4.2%.*
- But it is not reasonable to think that these particular areas of investment should robustly expand in the aftermath of a collapsed real estate bubble.

** Source: Bureau of Economic Analysis and author's calculations.*

Sluggish growth

- Sluggish growth leaves the U.S. economy vulnerable to further negative shocks.
- My expectation is still for modest and improving economic growth over the next year.
- However, should further weakness develop, monetary policy will need to respond appropriately.

The FOMC at another crossroads

- How should the Committee proceed in this circumstance, should further monetary policy action be warranted?
- The Fed is not now, or ever, “out of ammunition.”
- Still, the Fed cannot operate through its preferred channel, which is short-term nominal interest rates.
- I will now turn to discuss some guidelines concerning monetary policy in a continuing era of near-zero interest rates.

Embrace Rule-Like Behavior

Recent one-time policy actions

- Most monetary policy actions since the zero bound was encountered have been characterized by one-time policy announcements coupled with fixed end dates.

- This has been at odds with notions of optimal monetary policy developed over the last several decades.

- Most of the economic literature in the last 30 years has emphasized that a policy is not a one-time action but a rule mapping economic circumstances into changes in the policy instrument both today and in the future.

Past Committee behavior

- The Committee in the past did not contemplate announcing several hundred basis point interest rate moves with a fixed end date. Yet that is how the Committee behaves today.
- Instead the Committee announced a certain interest rate adjustment along with a continuation value, or bias, concerning future announcements.
- This approach served the Committee well for decades.
- Later research suggested that this type of policy approach was very close to the optimal policy arrangement.

Policy rules

- Today, attempts to influence nominal interest rates are increasingly irrelevant as the entire Treasury term structure is very low.
- Attempts to influence other, non-Treasury nominal interest rates directly would interfere with the risk premia attached to those yields.
- But the Committee can still control inflation through an appropriate balance sheet policy.
- The principle of adjusting policy meeting-by-meeting in reaction to economic events, along with a bias, applies to balance sheet policy as it did during interest rate targeting.

Rules versus discretion

- A meeting-by-meeting balance sheet policy constitutes a rules-based policy because the Committee would make adjustments in response to economic events, just as in the interest rate targeting world.

- In contrast, the policy approach of the last several years, with announcements of large dollar amounts, fixed end dates, and rapidly changing tactics, seems fairly discretionary.

- Returning to a more rules-based approach may provide needed stability to the U.S. macroeconomy.

Transmission

Transmission

- How can monetary policy be conducted when nominal interest rates are so close to zero?
- I believe it is important to think in terms of inflation and expected inflation.
- With the policy rate at zero, higher expected inflation lowers real interest rates.
- This is stimulative monetary policy by conventional definitions.

Influencing expected inflation

- Outright purchases of government debt by the monetary authority are considered inflationary, and rightly so.

- There is ample international evidence over decades and centuries that too much of this activity is associated with increases in inflation.

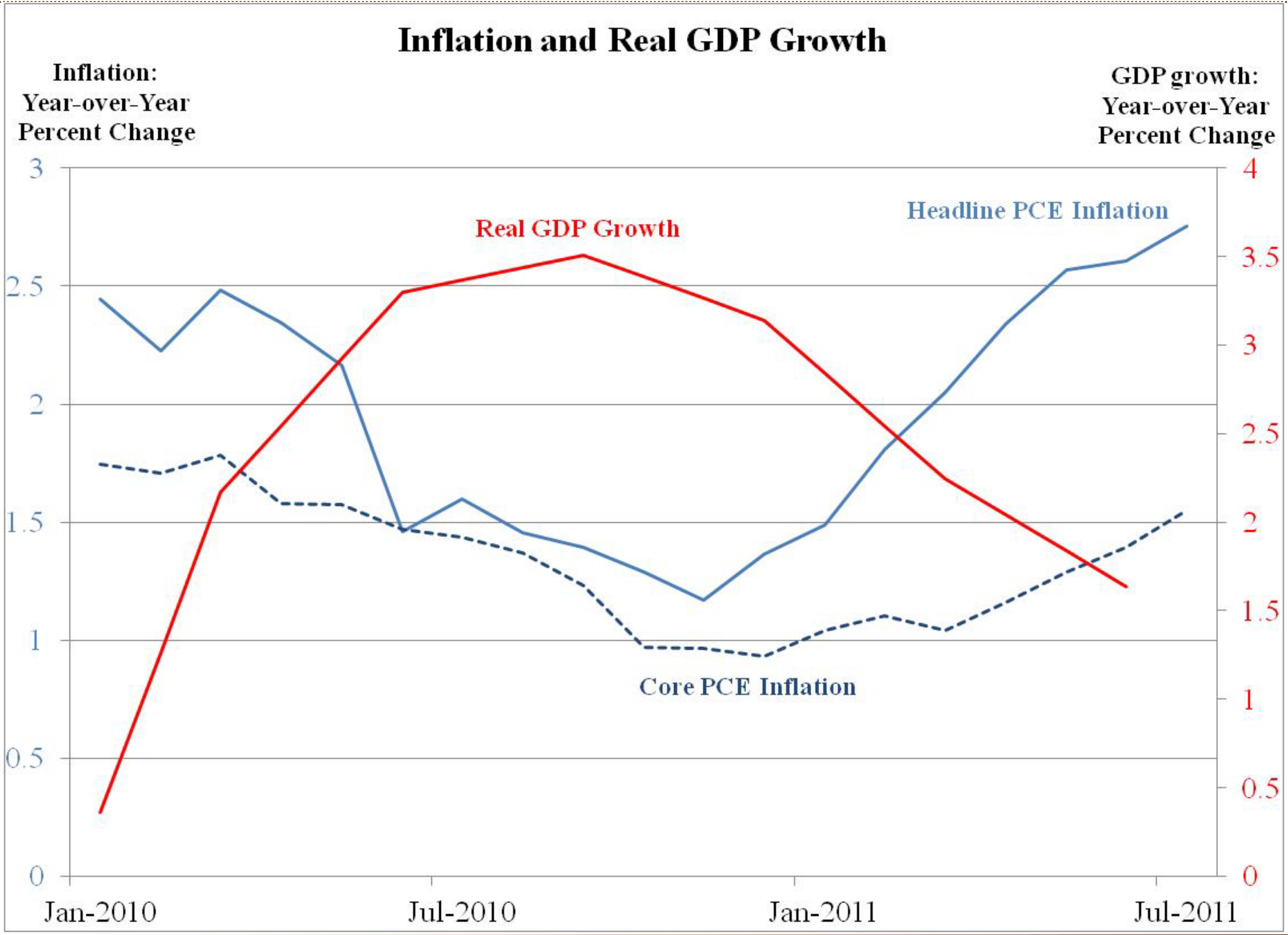
- This channel can be used to help keep inflation near target during the current unusual circumstance, and to help provide some support to the nation's economic recovery.

A potent tool

- Outright asset purchases are a potent tool and must be employed carefully.
- For a review of the evidence on QE2, see my discussion "The Effectiveness of QE2." *
- Inflation and inflation expectations rose during the last year, even though many measures of economic performance indicate that the economy was relatively weak.
- The meeting-by-meeting approach would allow the Committee to carefully monitor and adjust any program.

* Federal Reserve Bank of St. Louis *Regional Economist*, July 2011, p. 3.

Inflation turns around



Source: Bureau of Economic Analysis and author's calculations. Last observations: July 2011 and 2011-Q2.

Some Alternatives

An alternative approach: the communications tool

- An alternative would be for the Committee to 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 monetary accommodation if it so desires.
- This is the so-called communications tool.
- The communications tool works inside models but has some important caveats for actual policy application.

The communications tool: credible promises?

- One is that it is not clear how credible actual announcements can be.
- If the economy is actually performing quite 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 fall flat.

The communications tool: path to Japan?

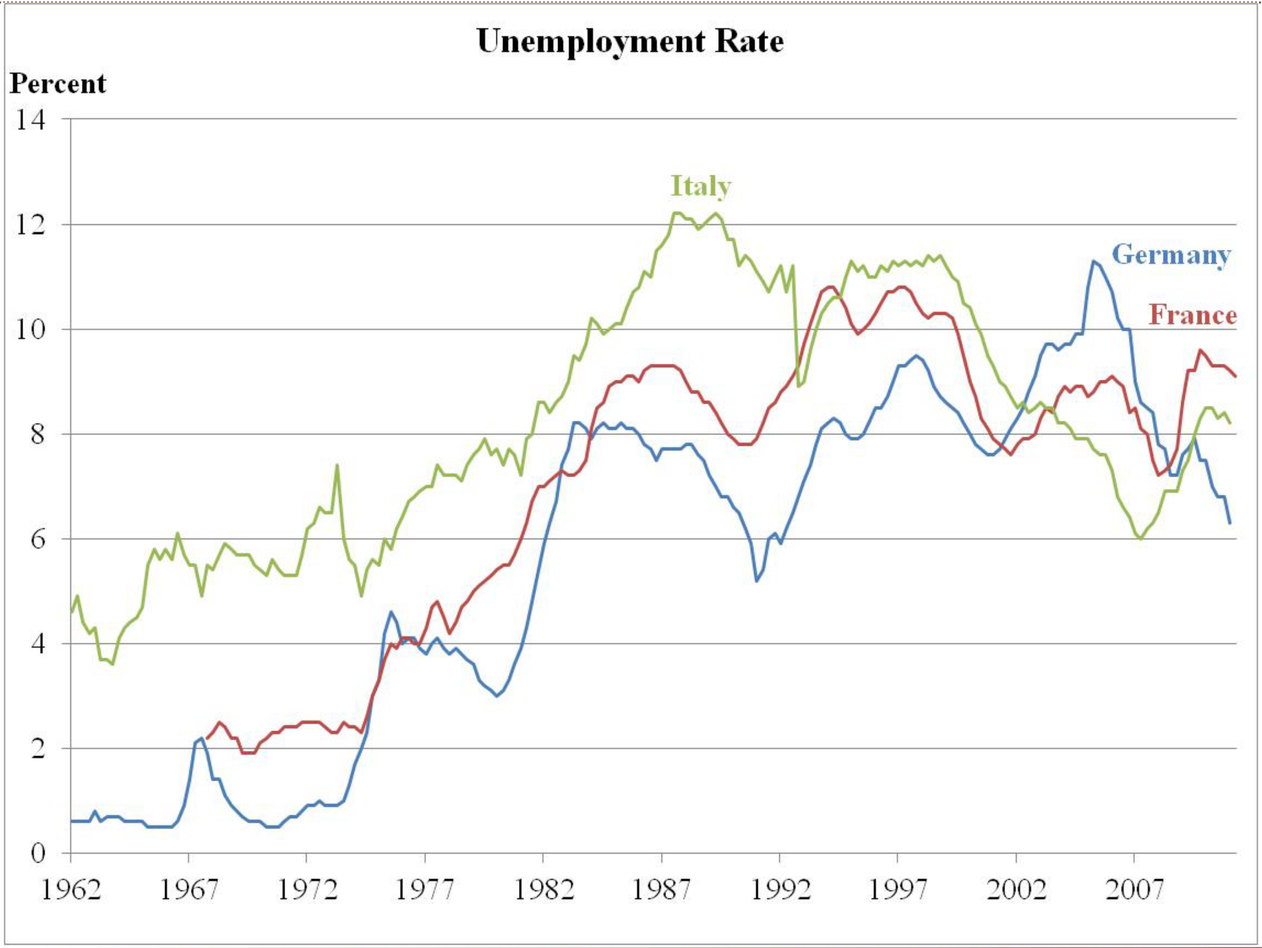
- There is another drawback to the communications tool.
- Simply promising to keep the policy rate near-zero for longer and longer periods of time may encourage a Japanese-style outcome in which the policy rate simply remains near zero and markets come to expect a mild rate of deflation.
- This possibility has clear support in the theoretical literature and in the Japanese data but is too often ignored in policy discussions.
- See the discussion in my paper, “Seven Faces of ‘The Peril’.” *

* Federal Reserve Bank of St. Louis *Review*, September/October 2010, *92*(5), pp. 339-52.

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.
- Unfortunately, unemployment rates have a checkered history in advanced economies over the last several decades.
- In particular, "hysteresis" has been a common problem, in which 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 explicitly tied to unemployment outcomes, monetary policy could be pulled off course for a generation.

European unemployment: hysteresis



Source: OECD Main Economic Indicators . Last observations: 2011-Q1 (Germany, Italy) and 2011-Q2 (France).

Conclusions

Conclusions

- U.S. monetary policy is again at a crossroads.
- Going forward, policy should strive to be more rules-based and less discretionary than it has been in the last three years.
- Monetary policy transmission can occur through expected inflation.
  - With nominal rates at zero, higher expected inflation lowers real interest rates.
  - The Committee still has to judge tradeoffs between inflation and support for the recovery.
- A communications policy which stresses longer and longer periods of near-zero policy rates may be counterproductive.

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