The U.S. Monetary Policy Outlook

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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.
Themes

- Brighter prospects for the U.S. economy provide the FOMC with the opportunity to pause in its aggressive easing campaign.

- The U.S. output gap is likely smaller than many estimates suggest.

- The FOMC’s “late 2014” language may be counterproductive.
Background

- This presentation is based in part on my recent speech in Hong Kong, “Monetary Policy and the U.S. Economy in 2012,” delivered March 23, 2012.

- The speech is available on my web page:
  - http://research.stlouisfed.org/econ/bullard/
Monetary Policy on Pause
The FOMC on pause

At the March meeting, the Committee updated its assessment of the economy, but otherwise left the policy statement largely unchanged.

Incoming data have generally indicated somewhat better-than-expected macroeconomic performance so far this year.

Past behavior of the Committee suggests a “wait-and-see” strategy at this juncture.
The ultra-easy policy

The Committee:

- Preemptively lowered the policy rate in early 2008.
- Lowered the policy rate nearly to zero in December 2008.
- Purchased mortgage-backed securities in 2009.
- Executed QE2 beginning in November 2010.
- Authorized a modern “Operation Twist” in September 2011.
- Began using explicit dates to describe the length of the near-zero rate policy.
The risk of over-commitment to the ultra-easy policy

- The ultra-easy policy has been appropriate until now, but it will not always be appropriate.

- Many of the further policy actions the Committee might consider at this juncture would have effects extending out for several years.

- As the U.S. economy continues to rebound and repair, additional policy actions may create an over-commitment to ultra-easy monetary policy.

- An appropriate approach at this juncture may be to continue to pause to assess developments in the economy.
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 directly address unemployment instead of taking further risks with monetary policy.

Brighter Prospects
The recession scare and its avoidance

- Last August, forecasters marked up the probability that the U.S. would fall into recession during the second half of 2011.

- Much of this was because of the July 29th GDP report.

- In addition, the European sovereign debt crisis worsened.

- Since last fall, the outlook has improved.
The entire path of GDP marked down

Equity valuations fell sharply

U.S. market volatility increased

ECB long-term refinancing calms markets

- The ECB offered three-year refinancing at low rates on broadened collateral in December.

- A second tranche was offered in February.

- At least for now, this has calmed European markets relative to last fall.

- The ECB policy does not address longer-term problems.
European markets calmer

European markets calmer

European CDS still elevated

Financial stress falls in the U.S.

Output Gaps and 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 may not be 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.
Decomposing real GDP

- The linear detrending method suggests the gap is large and that extraordinary business cycle stabilization measures are warranted.

- The Hodrick-Prescott filter detrending method suggests that most of the business cycle frequency adjustment has already taken place.
  - The economy is not performing in a satisfactory way, but that is a matter of trend dynamics, not business cycle dynamics.

- Inflation has increased during the last 18 months, favoring the interpretation that business cycle adjustment is largely complete.
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: Census Bureau and author’s calculations. Last observation: February 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.
Recent Monetary Policy
The communications tool

- The Committee could use the promised date of the first interest rate increase as a policy tool.

- 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, cancels out the initial effects of the promise, and so nothing is accomplished by making the initial promise.

- A non-credible announcement would be unhelpful.
The communications tool: counterproductive

- Besides being ineffective, there is an important downside.

- The 2014 language in effect names a date far in the future at which macroeconomic conditions are still expected to be exceptionally poor.
  - Neither the Fed nor any other forecaster has a clear idea of what macroeconomic conditions will be like at that time.

- This is an unwarranted pessimistic signal for the FOMC to send.
Conclusions
Recap

- U.S. monetary policy is on pause and may remain so in order to assess whether recent improvements in the U.S. economy continue.

- The U.S. output gap may be smaller than typical estimates suggest.
  - Typical estimates count the “housing bubble” of the mid-2000s as part of the normal level of output.

- The Committee’s practice of including distant dates in the statement sends an unwarranted pessimistic signal concerning the future of the U.S. economy.