The U.S. Monetary Policy Outlook

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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.

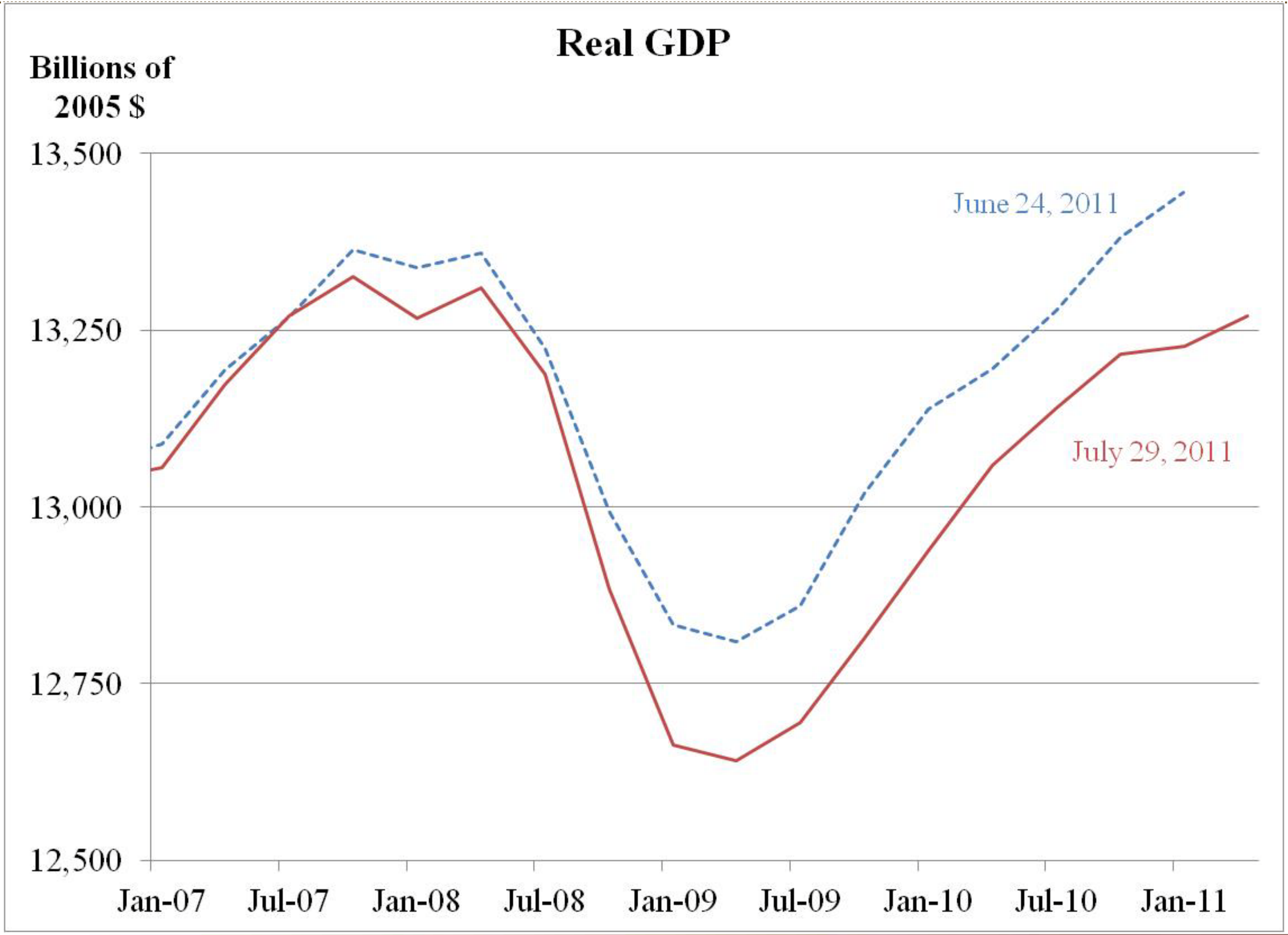
** Source: Bureau of Labor Statistics. February 2012 data.*

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

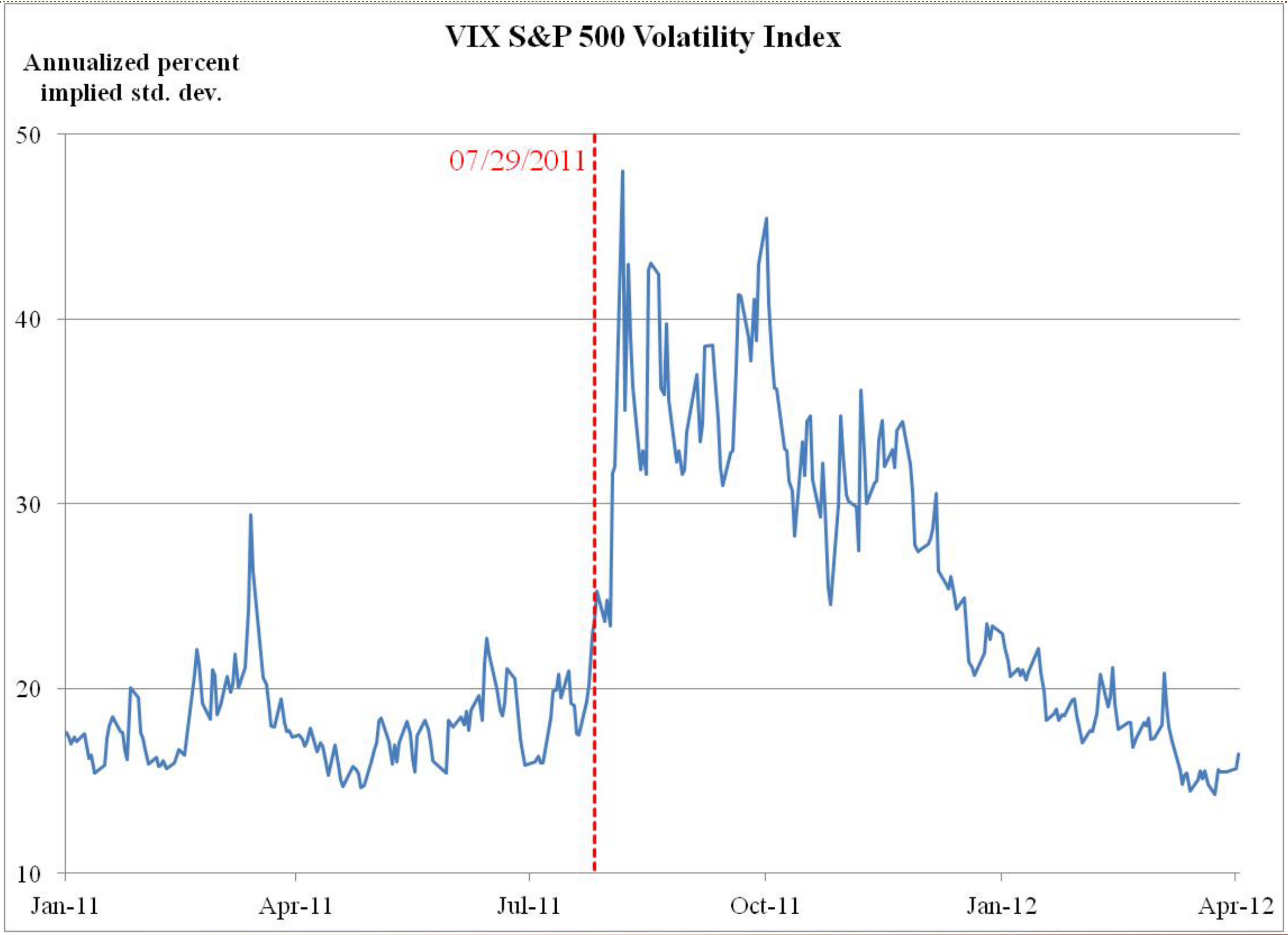


Source: Bureau of Economic Analysis. Last observation: 2011-Q2.

Equity valuations fell sharply

Source: Wall Street Journal. Last observation: April 4, 2012.

U.S. market volatility increased

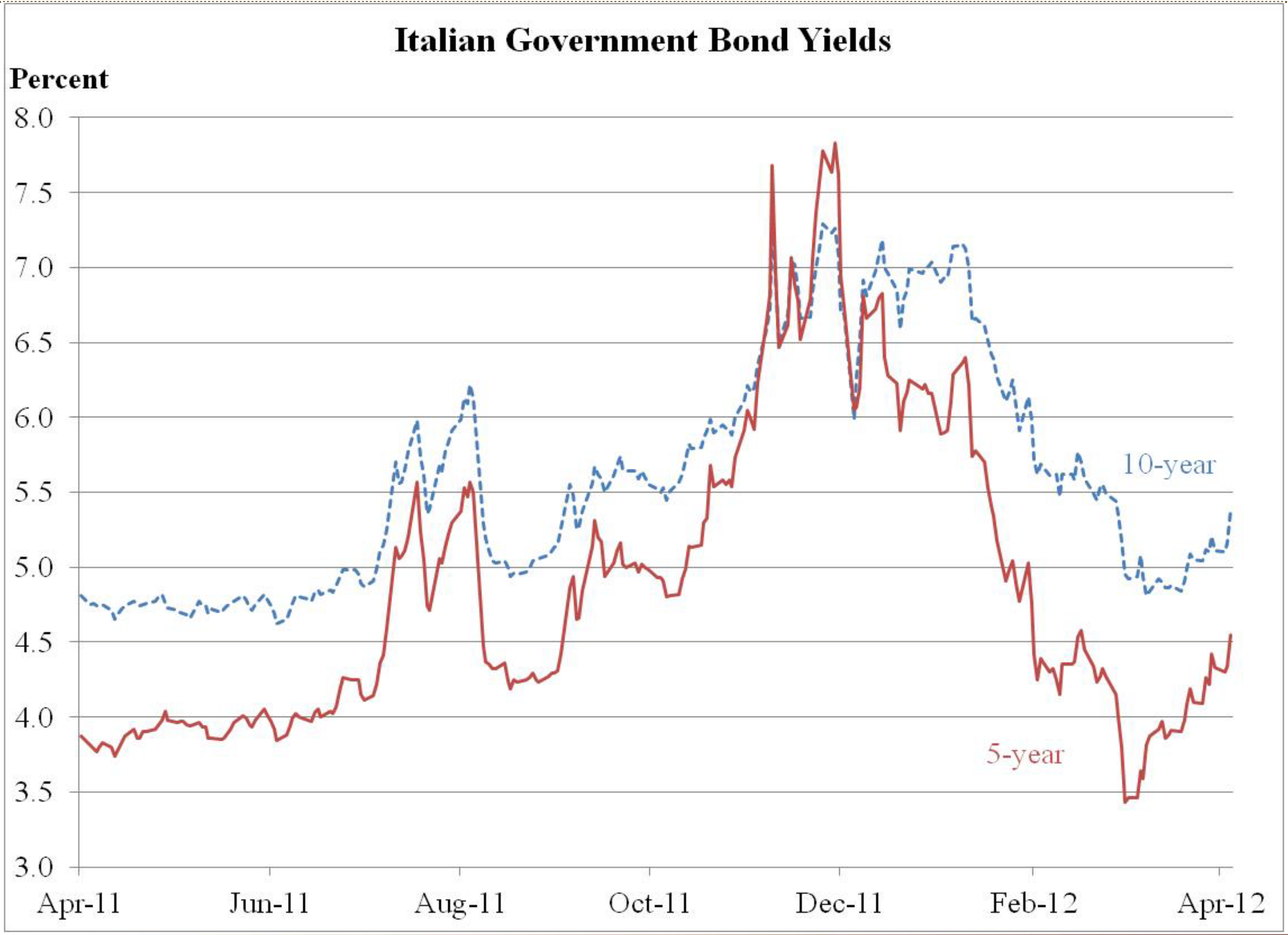


Source: Wall Street Journal. Last observation: April 4, 2012.

ECB long-term refinancing calms markets

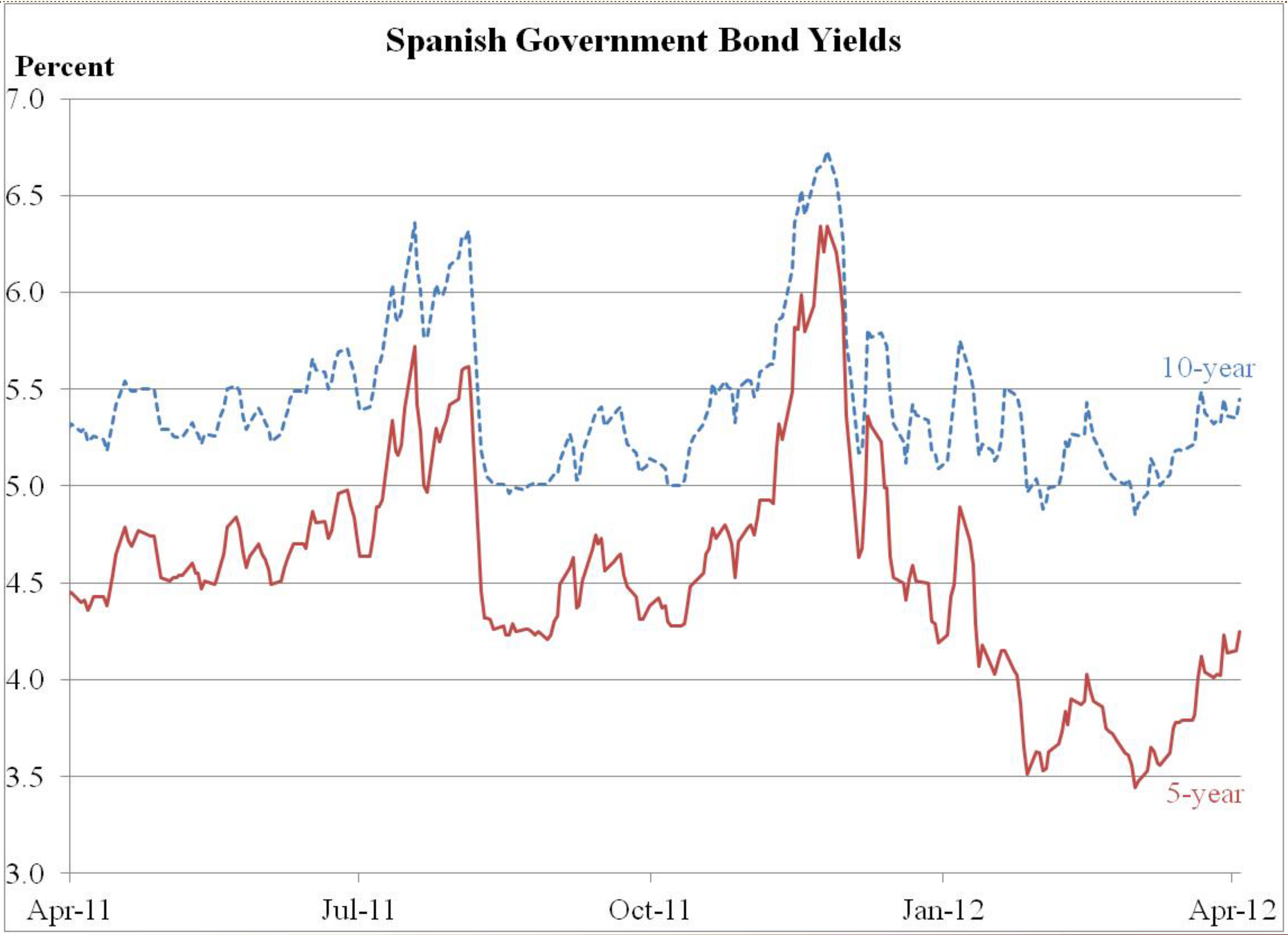
- The ECB offered three-year refinancing at low rates on broadened collateral in December.
- A second tranche was offered in February.
- At least for now, this has calmed European markets relative to last fall.
- The ECB policy does not address longer-term problems.

European markets calmer



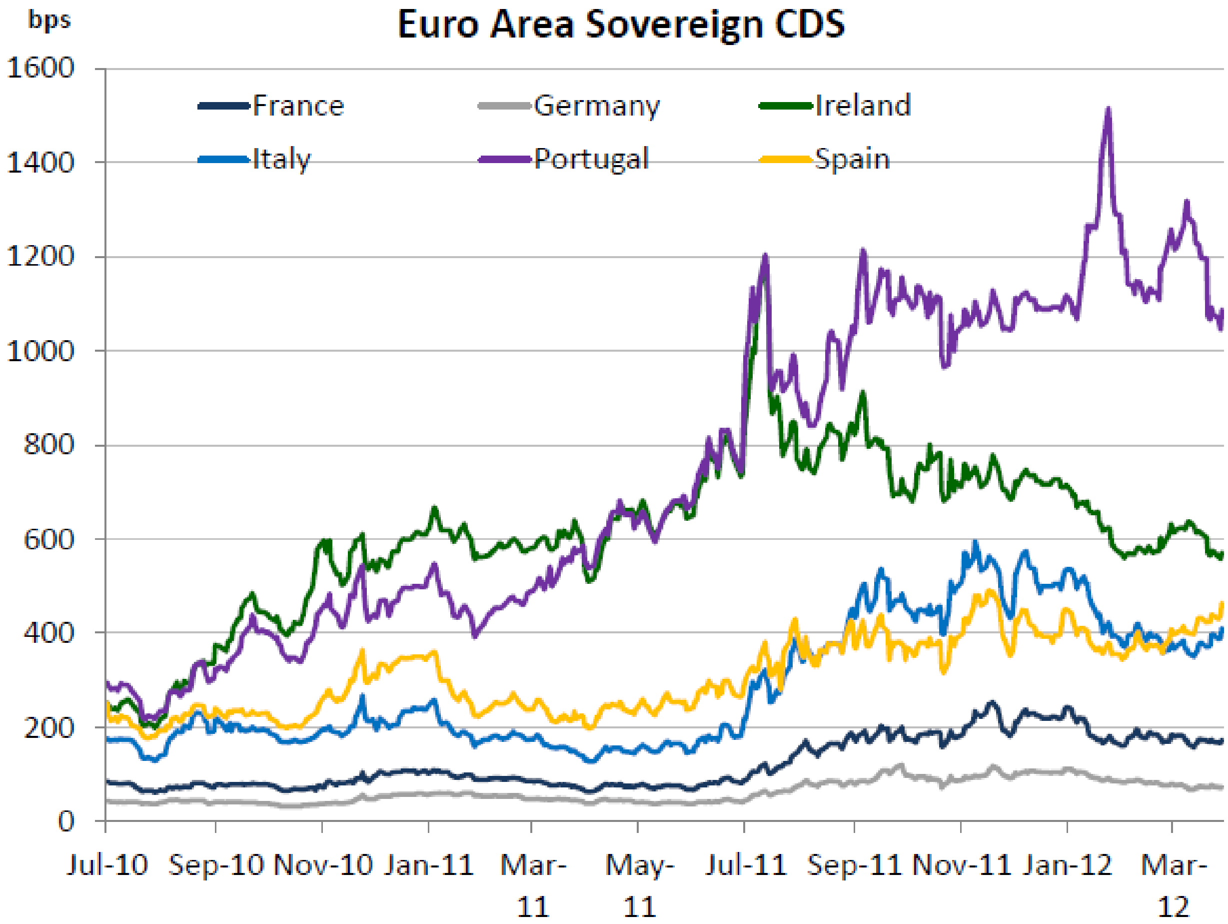
Source: Reuters. Last observation: April 4, 2012.

European markets calmer



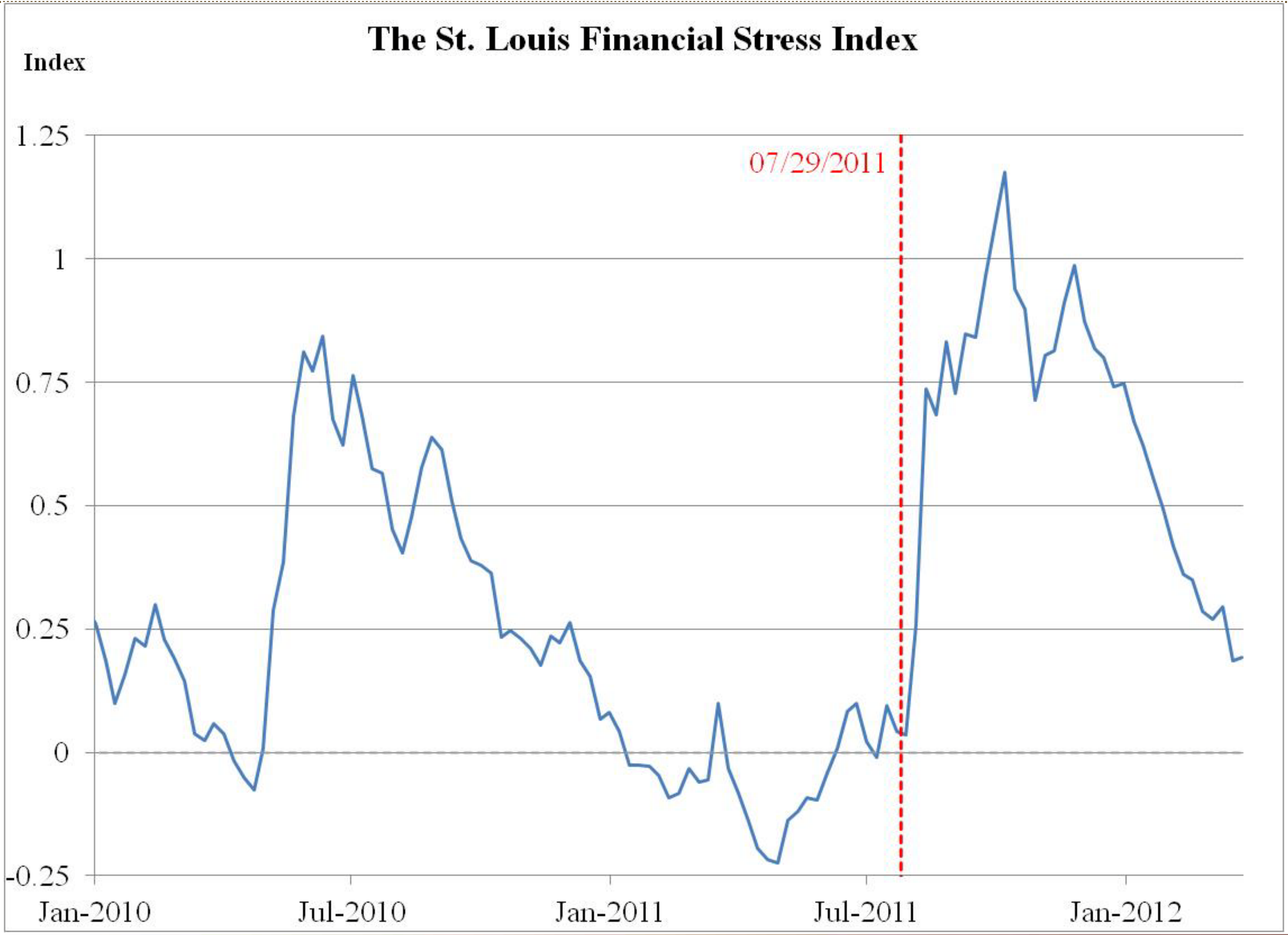
Source: Reuters. Last observation: April 4, 2012.

European CDS still elevated



Source: Federal Reserve Bank of New York. Last observation: April 3, 2012.

Financial stress falls in the U.S.



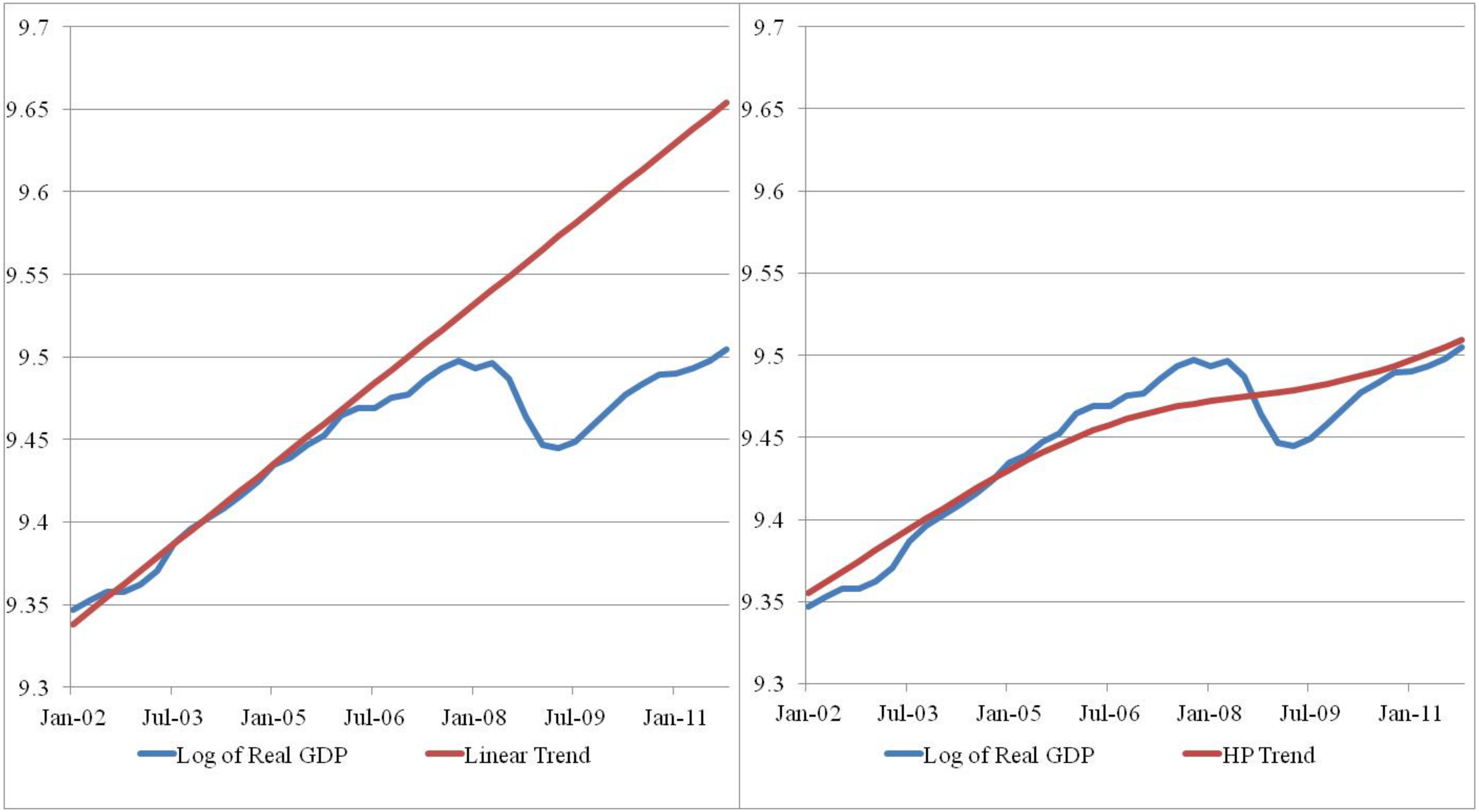
Source: Federal Reserve Bank of St. Louis. Last observation: week of March 23, 2012.

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

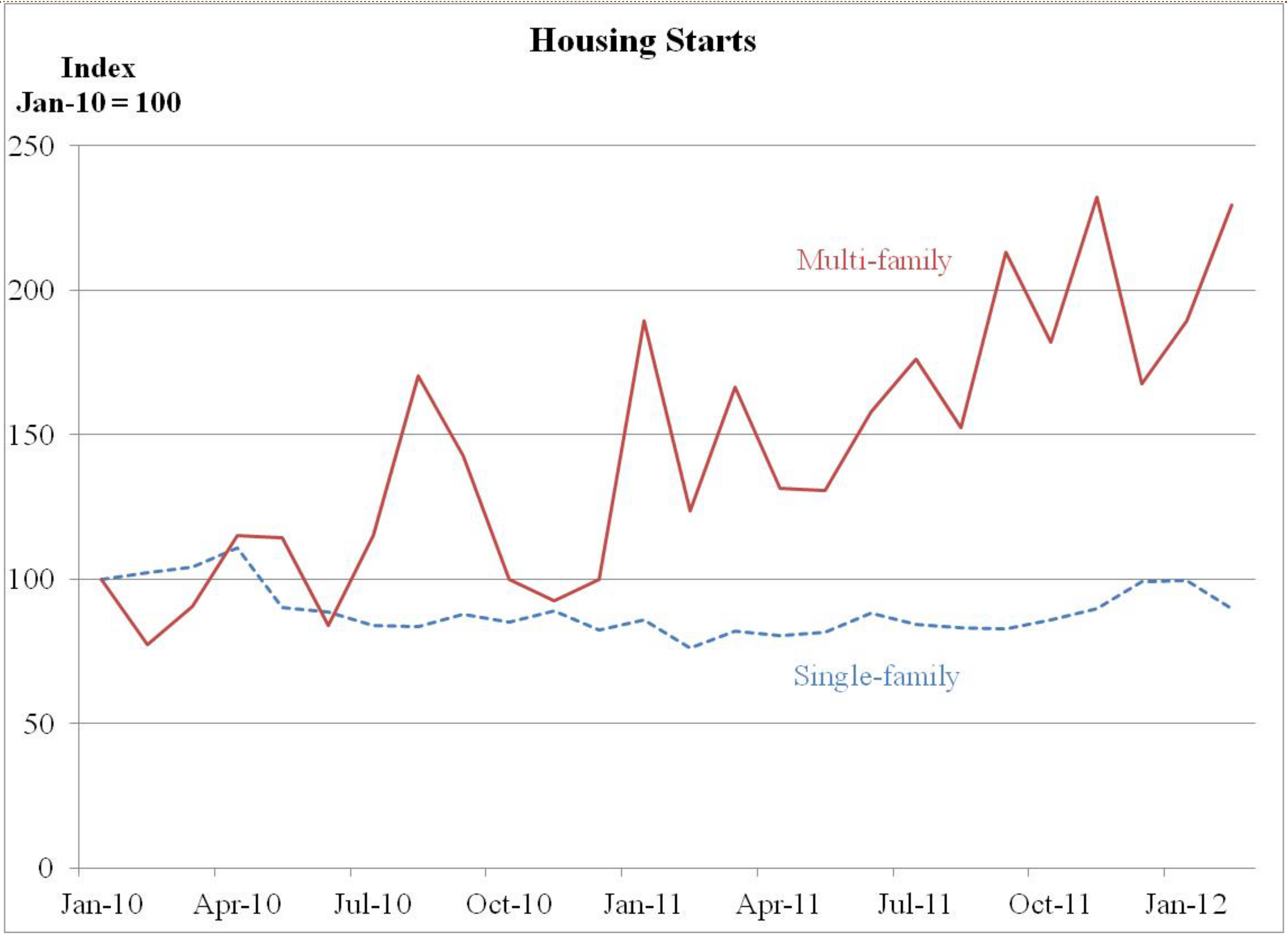
- The linear detrending method suggests the gap is large and that extraordinary business cycle stabilization measures are warranted.
- The Hodrick-Prescott filter detrending method suggests that most of the business cycle frequency adjustment has already taken place.
  - The economy is not performing 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

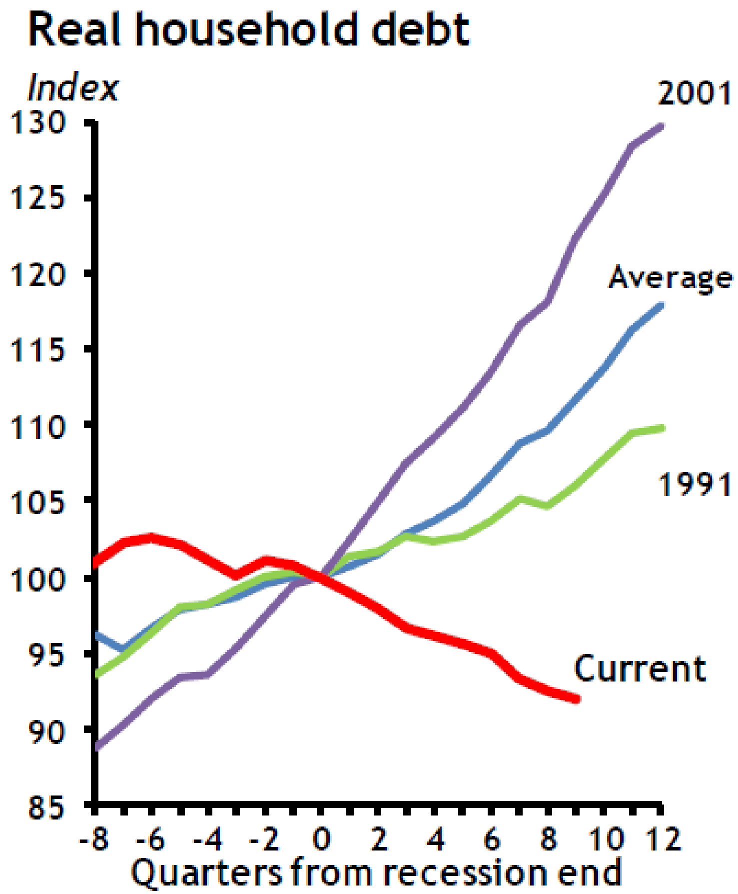


Source: Census Bureau and author's calculations. Last observation: February 2012.

Too much debt

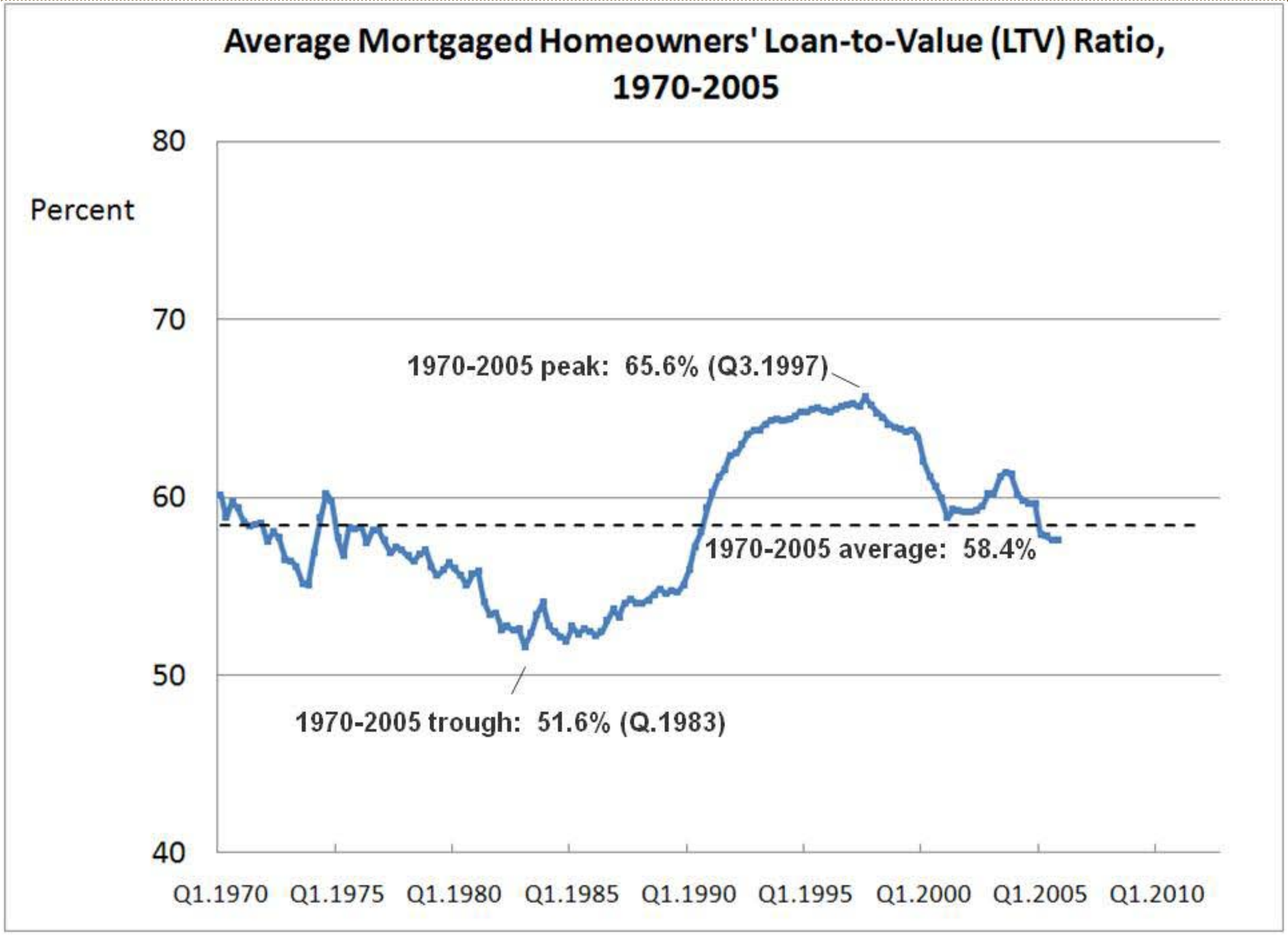
- The crisis has also saddled U.S. households with much more debt than they intended to take on.
- This is the first U.S. recession in which deleveraging has played a key role.

Real household debt



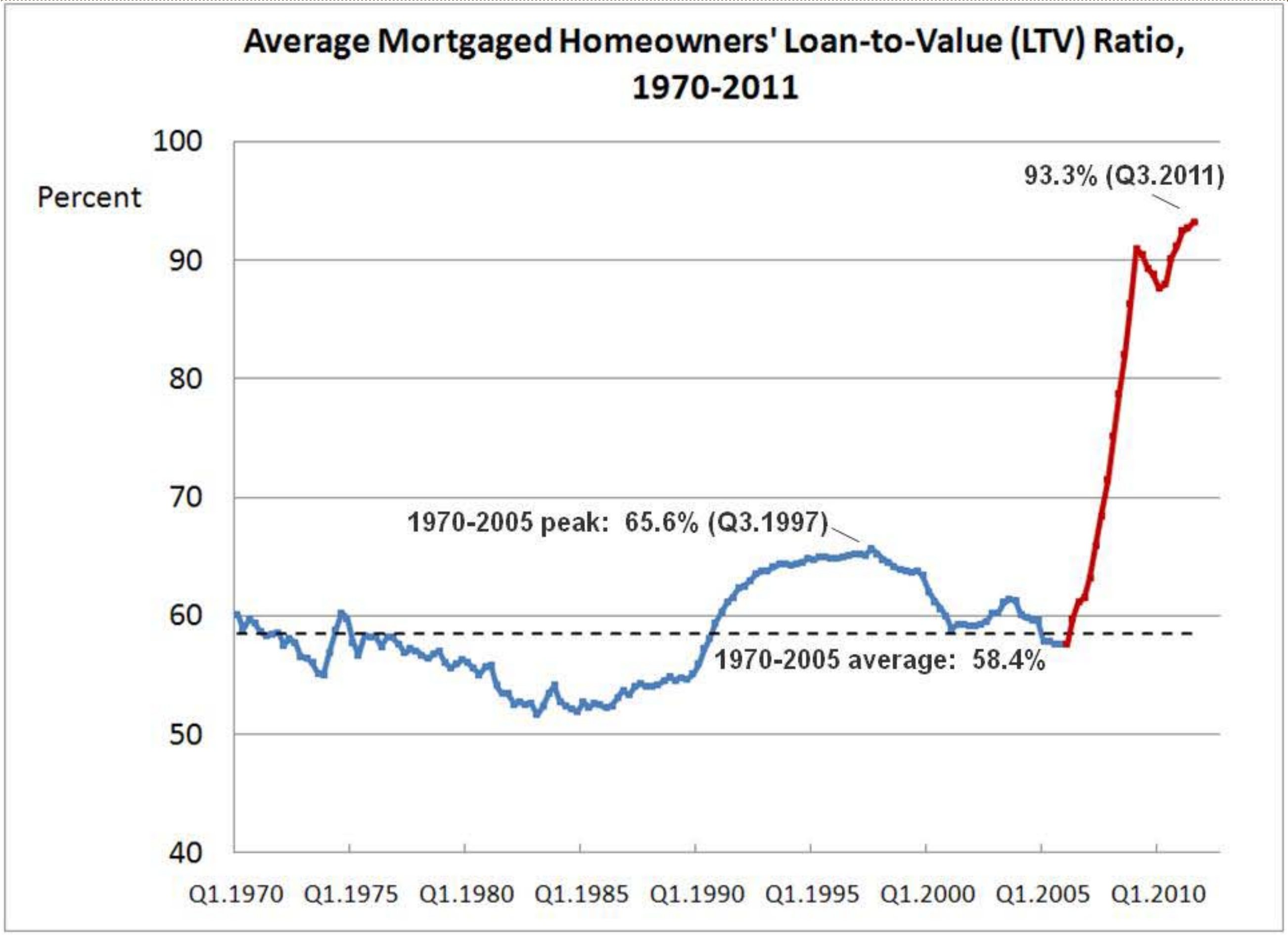
Source: Feroli et al. (2012).

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.

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