

Monetary Policy and Economic Developments

As required by section 2B of the Federal Reserve Act, the Federal Reserve Board submits written reports to the Congress that contain discussions of “the conduct of monetary policy and economic developments and prospects for the future.” The *Monetary Policy Report to the Congress*, submitted semiannually to the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Banking and Financial Services, is delivered concurrently with testimony given by the Chairman of the Federal Reserve Board.

The following discussion is an annual review of U.S. monetary policy and economic developments in 2010. It includes the text, tables, and selected figures from the March 1, 2011, report; the figures have been renumbered, and therefore the figure numbers differ from those in the report. Also included are the text and table from [Parts 1–3](#) of the July 21, 2010, report; [Part 4](#) of that report is identical to the [addendum](#) to the minutes of the June 22–23, 2010, meeting of the Federal Open Market Committee (FOMC) and is presented with those minutes in the “[Minutes](#)” [section](#) of this annual report.

The complete *Monetary Policy Reports* are available on the Board’s website at www.federalreserve.gov/boarddocs/hh. Other materials in this annual report related to the conduct of monetary policy include the minutes of the 2010 meetings of the FOMC (see the “[Minutes](#)” [section](#) on page 163) and statistical tables 1–4 (see the “[Statistical Tables](#)” [section](#) on page 293).

Monetary Policy Report of March 2011

Part 1

Overview: Monetary Policy and the Economic Outlook

Economic activity in the United States expanded at a moderate pace, on average, in the second half of 2010 and early 2011. In the spring and early summer, a

number of key indicators of economic activity softened relative to the readings posted in late 2009 and the first part of 2010, raising concerns about the durability of the recovery. In light of these developments—and in order to put the economic recovery on a firmer footing—the Federal Open Market Committee (FOMC) provided additional monetary policy stimulus during the second half of 2010 by reinvesting principal repayments from its holdings of agency debt and agency mortgage-backed securities in longer-term Treasury securities and by announcing its intention to purchase an additional \$600 billion of Treasury securities by the end of the second quarter of 2011.

Financial market conditions improved notably in the fall of 2010, partly in response to actual and expected increases in monetary policy accommodation. In addition, later in the year, the tenor of incoming economic news strengthened somewhat, and the downside risks to economic growth appeared to recede. Nonetheless, the job market has improved only slowly. Employment gains have been modest, and although the unemployment rate fell noticeably in December and January, the margin of slack in the labor market remains wide. Meanwhile, despite rapid increases in commodity prices, longer-term inflation expectations remained stable, and measures of underlying consumer price inflation continued to trend downward on net.

Real gross domestic product (GDP) rose at a moderate rate in the third quarter. Inventories provided the principal impetus to growth while final sales showed little vigor—the same pattern that prevailed in the first half of the year. Less favorable readings that began to emerge during the second quarter for a range of indicators—new claims for unemployment insurance, industrial production, and numerous surveys of business activity, among others—pointed to a slowing in the pace of the recovery and suggested that the transition from a recovery boosted importantly by the inventory cycle to one propelled mainly by private final demand was proceeding only very

gradually. Later in the year, however, this process appeared to gain traction. Indeed, real GDP is estimated to have risen a little faster in the fourth quarter than in the third quarter despite a substantial slowdown in the pace of inventory investment in the fourth quarter; final sales increased much more rapidly in the fourth quarter than earlier.

Over the second half of 2010, consumer spending posted a solid gain, boosted in part by continued, albeit modest, increases in real wage and salary income; some waning of the drag on outlays from earlier declines in household net worth; and a modest improvement in the availability of consumer credit. Businesses continued to step up their spending on equipment and software in response to a brighter outlook for sales as well as more favorable conditions in credit markets. In the external sector, the continued rebound in exports was supported by firming foreign demand. Meanwhile, the construction sector remained exceptionally weak.

The continued recovery in economic activity has been accompanied by only a slow improvement in labor market conditions. Private payroll employment has moved up at a relatively tepid rate—about 115,000 per month, on average, since the February 2010 trough in employment—recouping only a small portion of the 8¾ million jobs lost during 2008 and 2009. Over most of this period, the pace of hiring was insufficient to substantially reduce the unemployment rate. In December and January, however, the jobless rate was reported to have declined noticeably. In addition to the recent drop in the unemployment rate, some other indicators of labor market conditions—for example, measures of firms' hiring plans—have brightened a bit, raising the prospect that a pickup in the pace of hiring may be in the offing. That said, the level of the unemployment rate remains very elevated, and the long-term unemployed continue to account for a historically large fraction of overall joblessness.

Consumer price inflation trended down during 2010 as slack in resource utilization restrained cost pressures while longer-term inflation expectations remained stable. Although the prices of crude oil and many industrial and agricultural commodities rose rapidly in the latter half of 2010 and the early part of 2011, overall personal consumption expenditures (PCE) prices increased at an annual rate of just 1¼ percent over the 12 months ending in January, which compares with a 2½ percent rise during the preceding 12 months. Core PCE prices—which

exclude prices for food and energy—rose ¾ percent in the 12 months ending in January.

Financial market conditions continued to be supportive of economic growth in the second half of 2010 and into 2011. Equity prices rose solidly, reflecting the more accommodative stance of monetary and fiscal policy, an improved economic outlook, and better-than-expected corporate earnings reports. Yields on longer-term Treasury securities declined in the summer and early autumn, reflecting in part anticipation of additional monetary policy stimulus, but subsequently rose as economic prospects improved and as market expectations of the ultimate size of FOMC Treasury purchases were revised down. Despite some volatility, yields on Treasury securities remained relatively low on balance. Medium- and longer-term inflation compensation derived from inflation-indexed Treasury securities increased since the summer as concerns about deflation eased, though these measures remained within historical ranges. Interest rates on fixed-rate residential mortgages moved broadly in line with yields on Treasury securities while the spreads between yields on corporate bonds and those on Treasury securities declined; overall, both mortgage rates and corporate yields continued to be at low levels. Although bank lending policies generally stayed tight, banks reported some easing in those conditions on net. After posting substantial declines since the third quarter of 2008, total loans held on the books of banks showed signs of stabilizing in recent months.

Larger nonfinancial corporations with access to capital markets took advantage of favorable financial conditions to issue debt at a robust pace. Bond and syndicated loan issuance was strong, particularly among lower-rated corporate borrowers. Commercial and industrial loans on banks' books started to expand around the end of 2010. Nevertheless, small, bank-dependent businesses remained constrained in their access to credit, although some indicators suggested that credit availability for these firms was beginning to improve.

Household debt appears to have contracted in the second half of 2010, but at a somewhat slower pace than earlier in the year. Household mortgage debt likely continued to decline, as housing demand remained weak and lending standards were reportedly still stringent. Revolving consumer credit also contracted. By contrast, nonrevolving consumer credit—primarily auto and student loans—increased solidly in the final quarter of 2010.

After first emerging during the spring, concerns about fiscal and banking developments in Europe resurfaced later in the year. Although some European sovereigns and financial institutions faced renewed funding pressures in the fourth quarter, the repercussions in broader global financial markets were muted. To help minimize the risk that strains abroad could spread to the United States, as well as to continue to support liquidity conditions in global money markets, the FOMC in December approved an extension of the temporary U.S. dollar liquidity swap arrangements with a number of foreign central banks.

Apparently seeking to boost returns in an environment of low interest rates, investors displayed an increased appetite for higher-yielding fixed-income instruments in the second half of 2010 and into 2011, which likely supported strong issuance of these products and contributed to a narrowing of risk spreads, such as those on corporate debt instruments. Information from a variety of sources, including the Federal Reserve Board's Senior Credit Officer Opinion Survey on Dealer Financing Terms, suggests that use of dealer-intermediated leverage by financial market participants rose a bit in recent quarters but remained well below its pre-crisis levels.¹ The condition of financial institutions generally appeared to improve further, and the regulatory capital ratios of commercial banks, particularly the largest banks, moved higher.

With the pace of recovery in output and employment seen as disappointingly slow and measures of inflation viewed as somewhat low relative to levels judged consistent with the Committee's mandate, the FOMC took several actions to provide additional support to the economic recovery during the second half of last year. In August, the FOMC decided to reinvest principal payments from agency debt and agency mortgage-backed securities held in the System Open Market Account (SOMA) in longer-term Treasury securities to keep constant the size of the SOMA portfolio and so avoid an implicit tightening of monetary policy. In November, to provide further policy accommodation to help support the economic recovery, the FOMC announced its intention to purchase an additional \$600 billion in longer-term Treasury securities by the end of the second quarter of 2011. Throughout the second half of 2010 and early 2011, the FOMC maintained a target range for the

federal funds rate of between 0 and ¼ percent and reiterated its expectation that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, were likely to warrant exceptionally low levels for the federal funds rate for an extended period.

The Federal Reserve continued to develop and test tools to drain or immobilize large volumes of banking system reserves in order to ensure that it will be able to smoothly and effectively exit from the current extraordinarily accommodative policy stance at the appropriate time. The Committee continues to monitor the economic outlook and financial developments, and it will employ its policy tools as necessary to support the economic recovery and to help ensure that inflation, over time, returns to levels consistent with its mandate.

The economic projections prepared in conjunction with the January FOMC meeting are presented in [Part 4](#) of this report. In broad terms, FOMC participants anticipated a sustained but modest recovery in real economic activity this year that would pick up somewhat in 2012 and 2013. The expansion was expected to be led by gains in consumer and business spending that are supported by improvements in household and business confidence. Nevertheless, economic growth was expected to be damped by a number of headwinds, including the gradual pace of improvements in the labor market, still-stringent borrowing conditions for households and bank-dependent small businesses, lingering household and business uncertainty, and ongoing weakness in real estate markets. On balance, FOMC participants anticipated that real GDP would increase at above-trend rates over the next three years, but not as rapidly as in previous recoveries. Meanwhile, the unemployment rate was projected to fall gradually. Inflation was expected to drift up slowly toward the levels that Committee participants believe to be most consistent with the Committee's mandate. Reflecting their assessment that the recovery appeared to be on a firmer footing, the participants upgraded slightly their projections for near-term economic growth relative to the ones they prepared in conjunction with the November FOMC meeting; otherwise, their projections for economic growth and inflation were little changed.

Participants generally judged that the uncertainty attached to their projections for both economic activity and inflation was greater than historical norms. A substantial majority of participants viewed the risks

¹ The survey is conducted quarterly and is available at www.federalreserve.gov/econresdata/releases/scoos.htm.

to both economic growth and inflation as balanced; only a few saw them as tilted either to the upside or to the downside. In November, a noticeable share of participants had seen the risks—particularly those to economic growth—as tilted to the downside. Participants also reported their assessments of the rates to which key macroeconomic variables would be expected to converge over the longer term under appropriate monetary policy and in the absence of further shocks to the economy. The central tendencies of these longer-run projections were 2.5 to 2.8 percent for real GDP growth, 5.0 to 6.0 percent for the unemployment rate, and 1.6 to 2.0 percent for the inflation rate.

Part 2 Recent Economic and Financial Developments

Economic activity expanded at a moderate pace, on balance, in the second half of 2010. According to the currently available estimates from the Bureau of Economic Analysis, real gross domestic product (GDP) increased at an annual rate of about 2¾ percent, on average, over that period (**figure 1**). In the third quarter, as had been the case in the first half of the year, much of the increase was the result of inventory accumulation; in contrast, final sales continued to rise at a subdued rate. Meanwhile, several indicators of economic activity had softened from the readings observed earlier in the year, raising concerns about the durability of the recovery. Later in the year, how-

ever, the tone of the incoming data on economic activity brightened somewhat, final sales strengthened, and the recovery appeared to be on a firmer footing.

Since the middle of 2010, consumer spending has risen solidly on average, businesses have continued to increase their outlays for equipment and software, and exports have moved up further. In contrast, construction of new homes and nonresidential buildings remains exceptionally weak. Conditions in the labor market have improved only slowly, with payrolls increasing at a modest pace. Throughout nearly all of 2010, that pace of employment expansion was insufficient to bring the unemployment rate down meaningfully from its recent peak. In December 2010 and January of this year, however, the unemployment rate is estimated to have dropped more noticeably, even though payroll employment gains remained lackluster. Meanwhile, long-duration joblessness persisted at near-record levels. With regard to inflation developments, despite rapid increases in commodity prices, longer-term inflation expectations have remained stable and consumer price inflation has continued to trend downward on net.

Conditions in financial markets generally improved over the course of the second half of 2010 and early 2011 and continued to be supportive of economic activity. This improvement reflected, in part, additional monetary policy stimulus provided by the Federal Reserve, as well as growing investor confidence in the sustainability of the economic recovery. Although yields on Treasury securities rose somewhat, on net, since mid-2010, yields on investment-grade corporate bonds were little changed at low levels, and yields on speculative-grade bonds declined. In equity markets, price indexes generally rose, buoyed by solid corporate earnings and a more positive economic outlook. Commercial banks reported that they had eased some of their lending standards and terms, though lending standards remained generally tight and some businesses and households continued to face difficulties obtaining credit. Changes in interest rates faced by households were mixed. The improvement in financial conditions was accompanied by some signs of a pickup in the demand for credit. Borrower credit quality generally improved, although problems persisted in some sectors of the economy. Concerns about European banking and fiscal strains increased again in late 2010 after having

Figure 1. Change in real gross domestic product, 2004–10

