Monetary Policy: Lessons from the Past and Looking Forward to the Future

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Three Big Events in Fed History

- **The Great Depression (1929-1938)**
  - "Inept monetary policy" failed to adequately combat credit contraction, deflation, and depression
- **The Great Inflation (1965-1980)**
  - Monetary policy failed to recognize structural changes and expectational dynamics that led to double-digit inflation
- **The Treasury Accord (1951)**
  - An example highlighting the importance of central bank independence

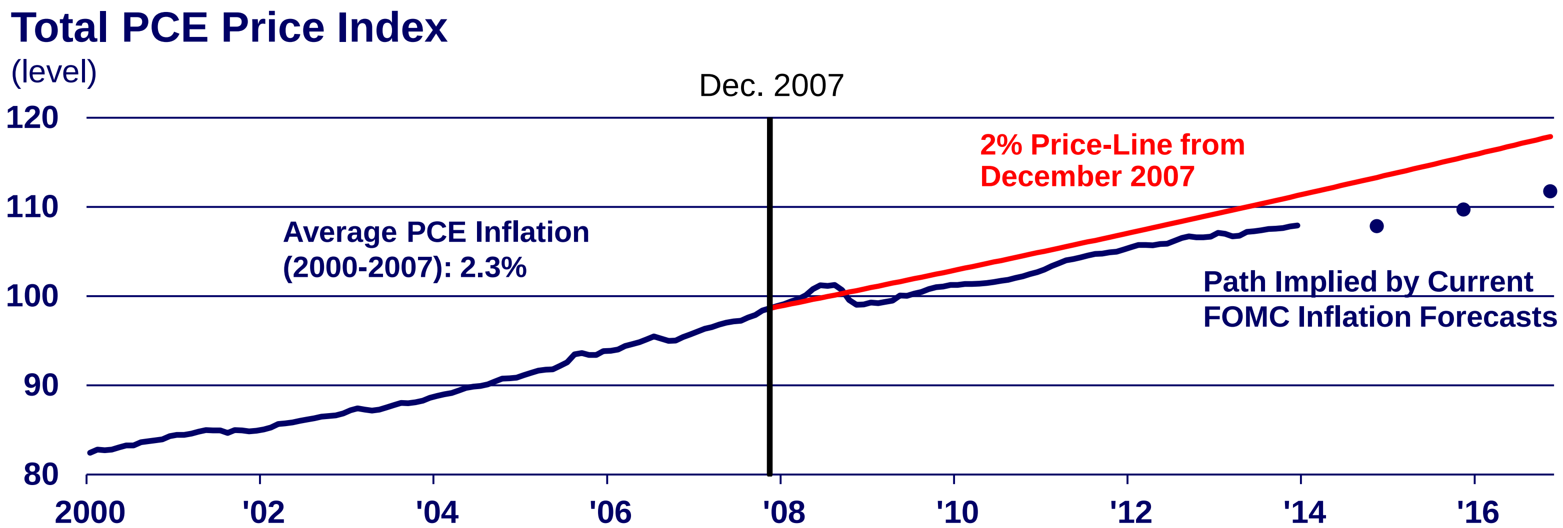
Long-Run Strategy for Monetary Policy
(January 2012, reaffirmed thereafter every January)

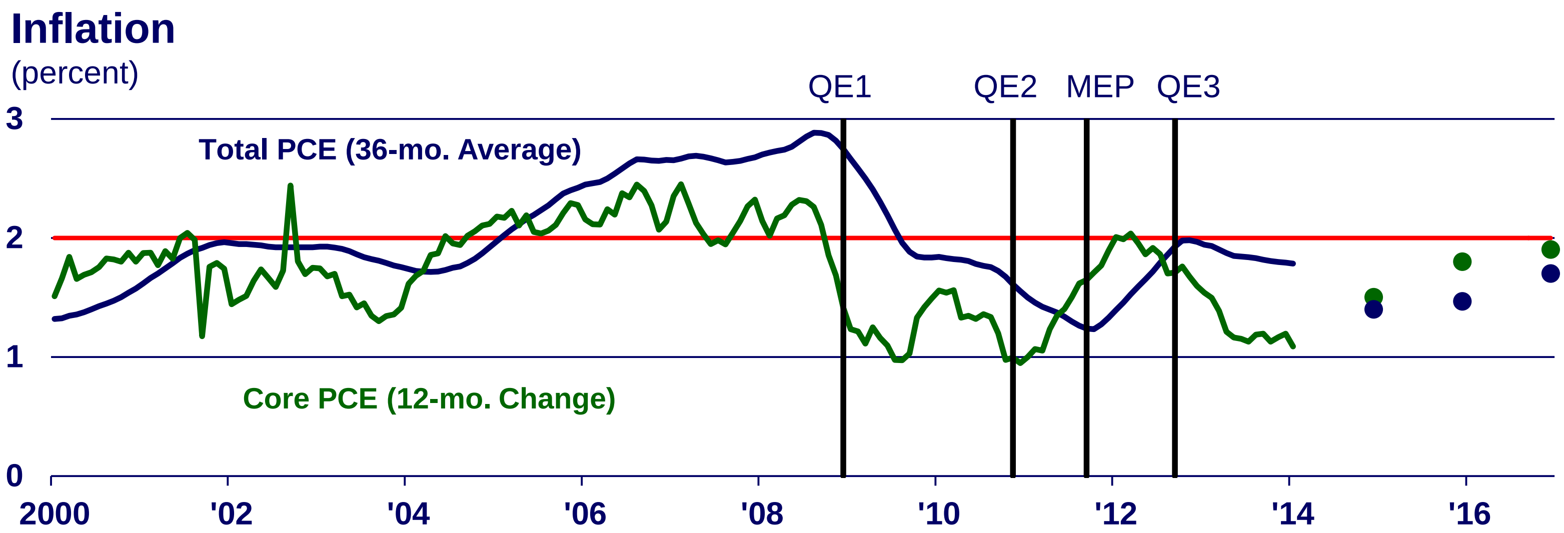
- **π^* = 2% PCE inflation**

- **U_t^* ~ 5.2% - 5.8%   time-varying**
  Central tendency of SEP longer-run normal rate

- **<u>Balanced approach</u> to reducing deviations of inflation and employment from long-run objectives**

Would Today's Dilemma Be Different under a Single Mandate?

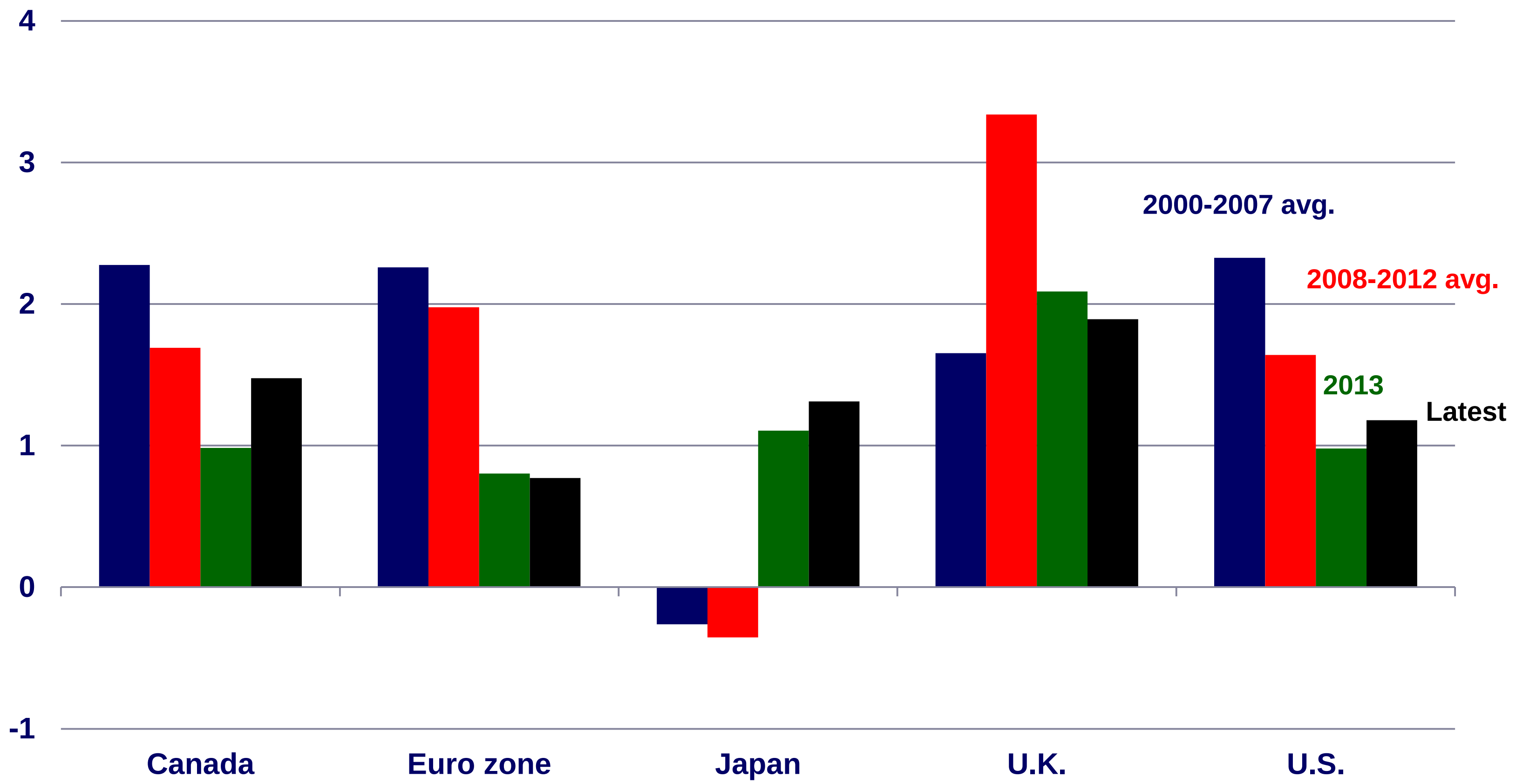




Source: Inflation forecasts are from the December 18, 2013 FOMC Summary of Economic Projections

Inflation Is Low Globally

Consumer Inflation*
(Q4/Q4 percent change)



*Consumer inflation in the U.S. is as measured by the total price index for Personal Consumption Expenditures; in other countries, it is measured by the Consumer Price Index. Latest data is year-over-year change in the monthly index.

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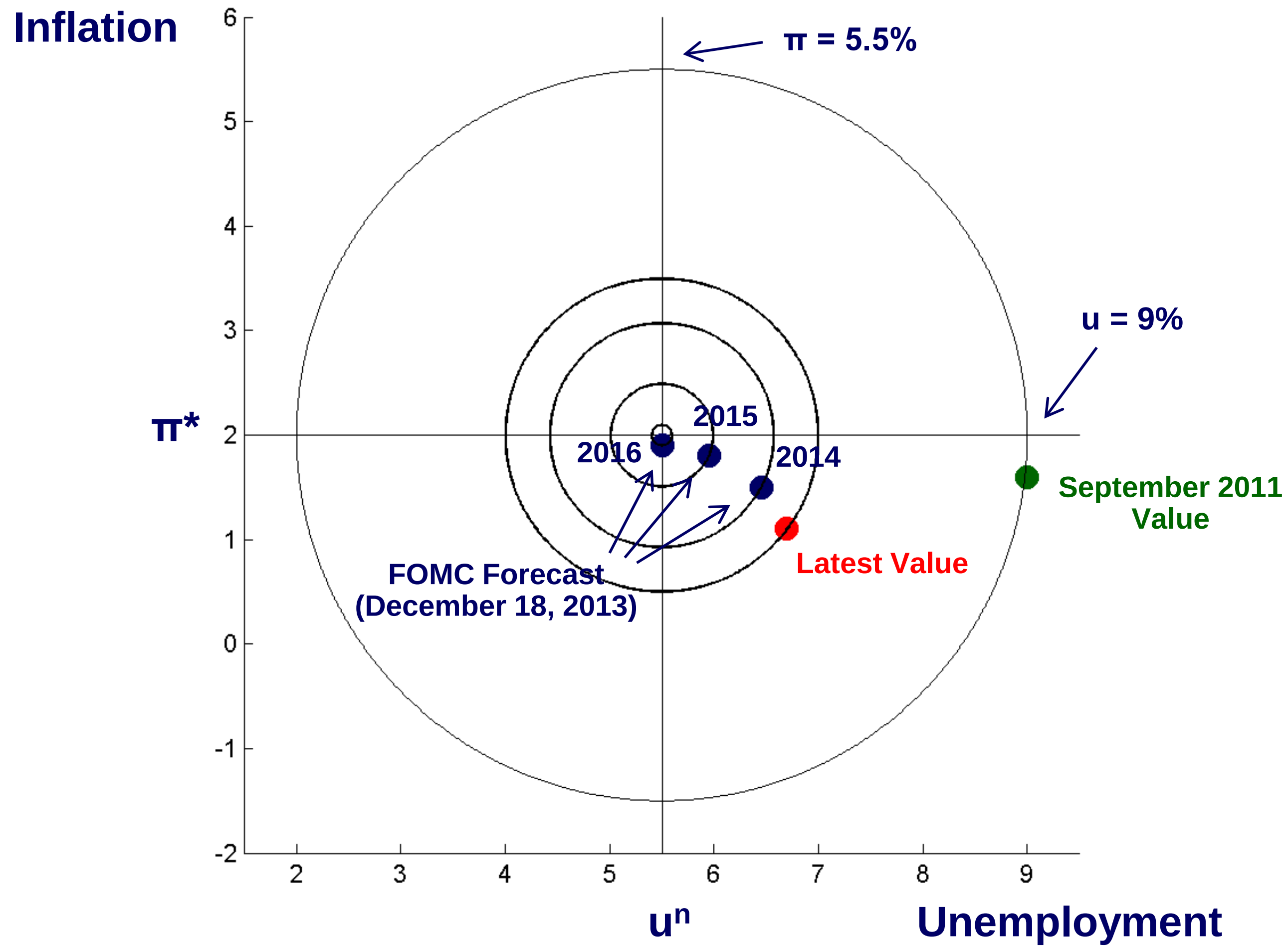
Balanced Approach to the Dual Mandate Is Consistent with Mainstream Macroeconomics

Loss Function
(percent)

$$L = (\pi - \pi^*)^2 + 0.25\,(y - y^*)^2$$

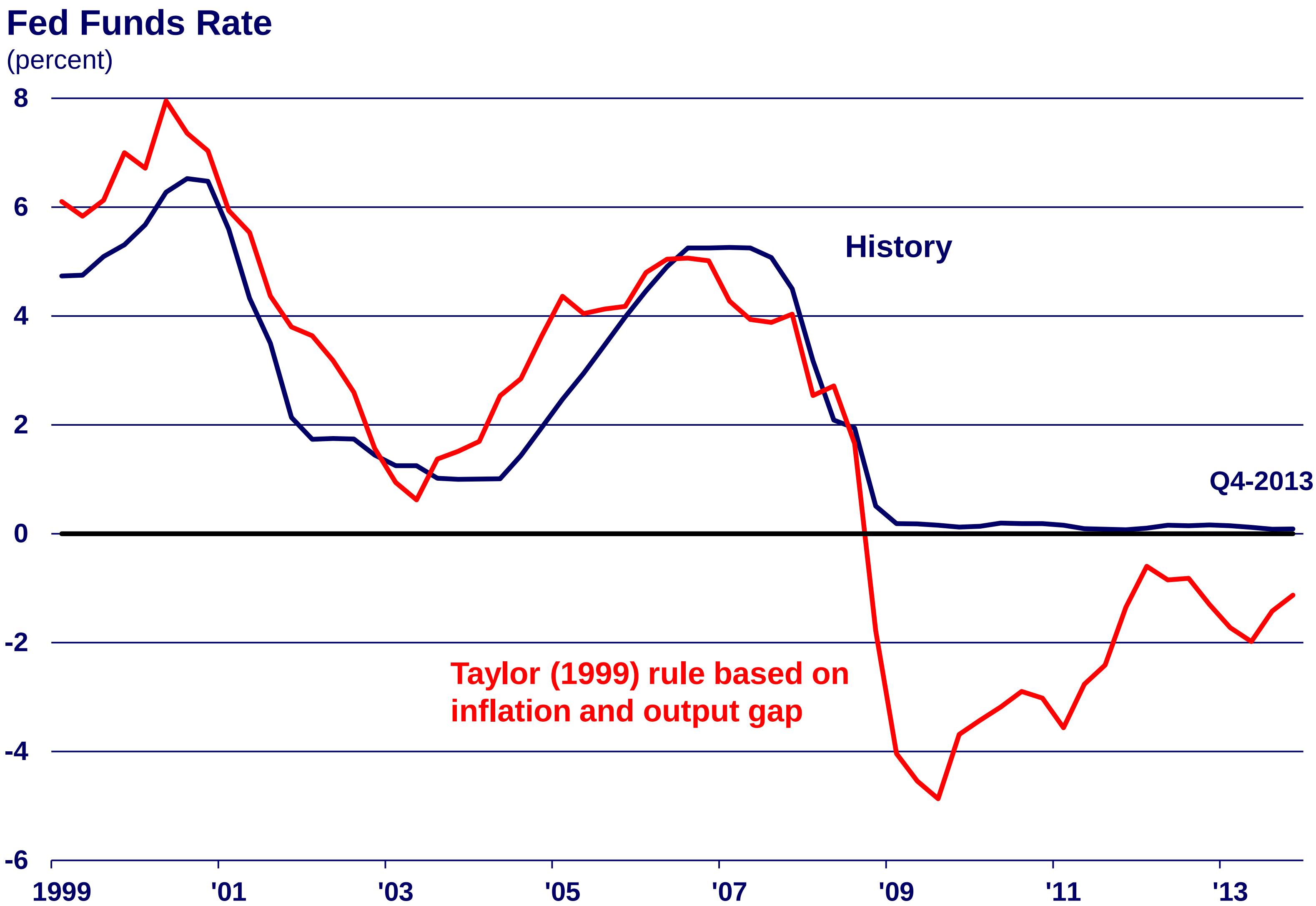
$$L = (\pi - 2)^2 + (u - u^n)^2$$



Why Has Achieving Dual Mandate Been So Hard?

- Deleveraging in the aftermath of the financial crisis
- Global risks
- Unusually restrictive fiscal policy
- Monetary policy constrained by zero lower bound

Policy Rate Constrained by Zero Lower Bound



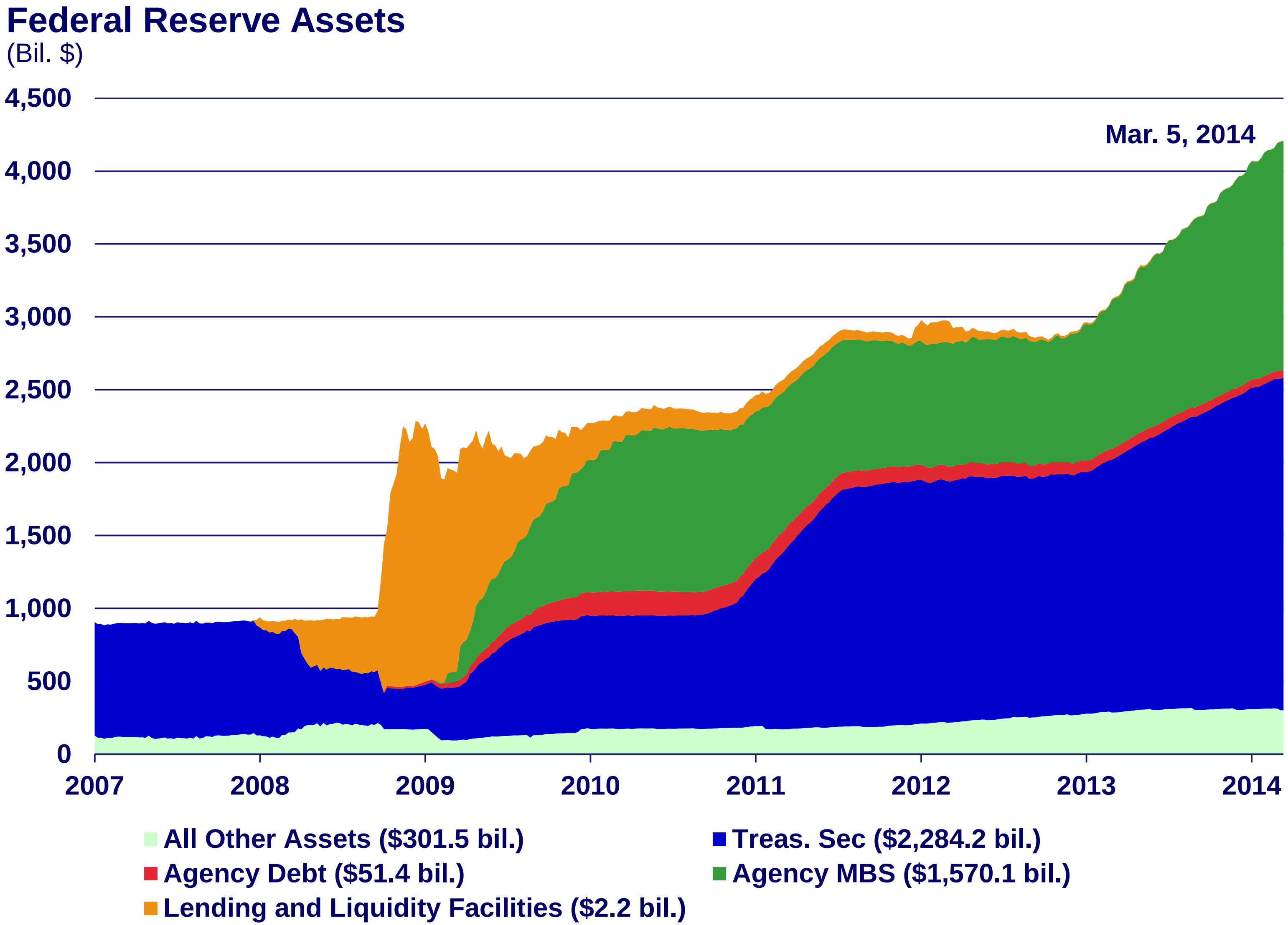
Policy Tools at the Zero Lower Bound

- **Large Scale Asset Purchases**

- **Forward Guidance**

- **Features of Both Unconventional Tools**
  - Lower long-term interest rates
  - Disciplined by economic conditionality

Asset Purchases: The Fed's Balance Sheet



Forward Guidance on the Federal Funds Rate

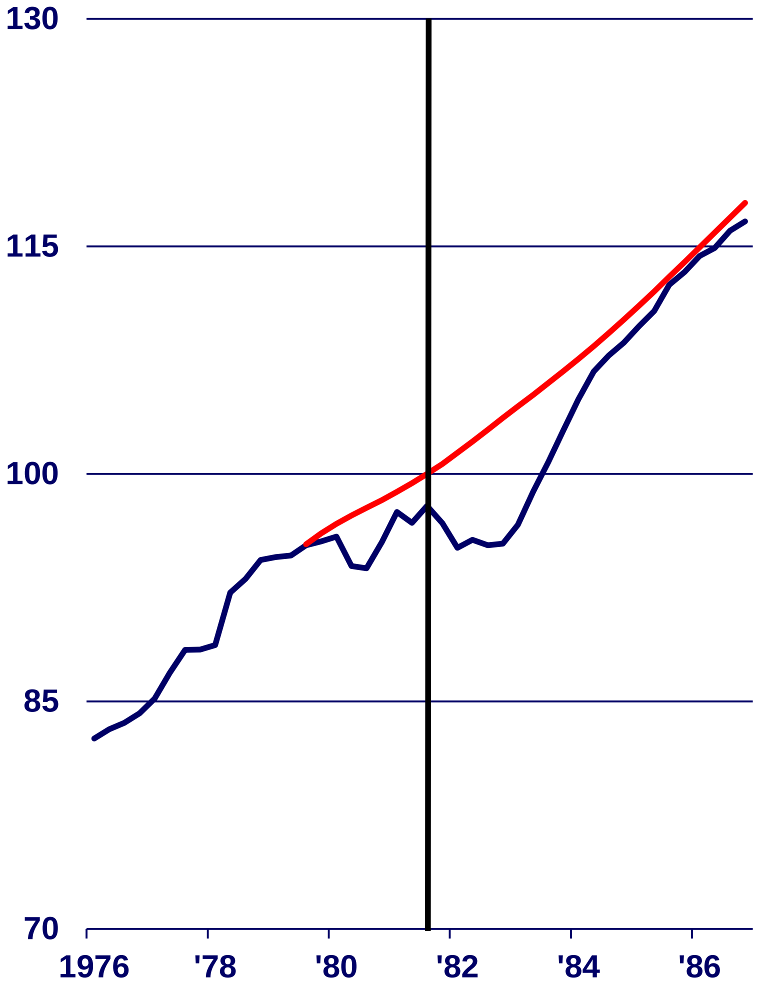
- **Zero interest rate <u>at least</u> until U < 6.5% or π > 2.5%**

- **Thresholds, not triggers**

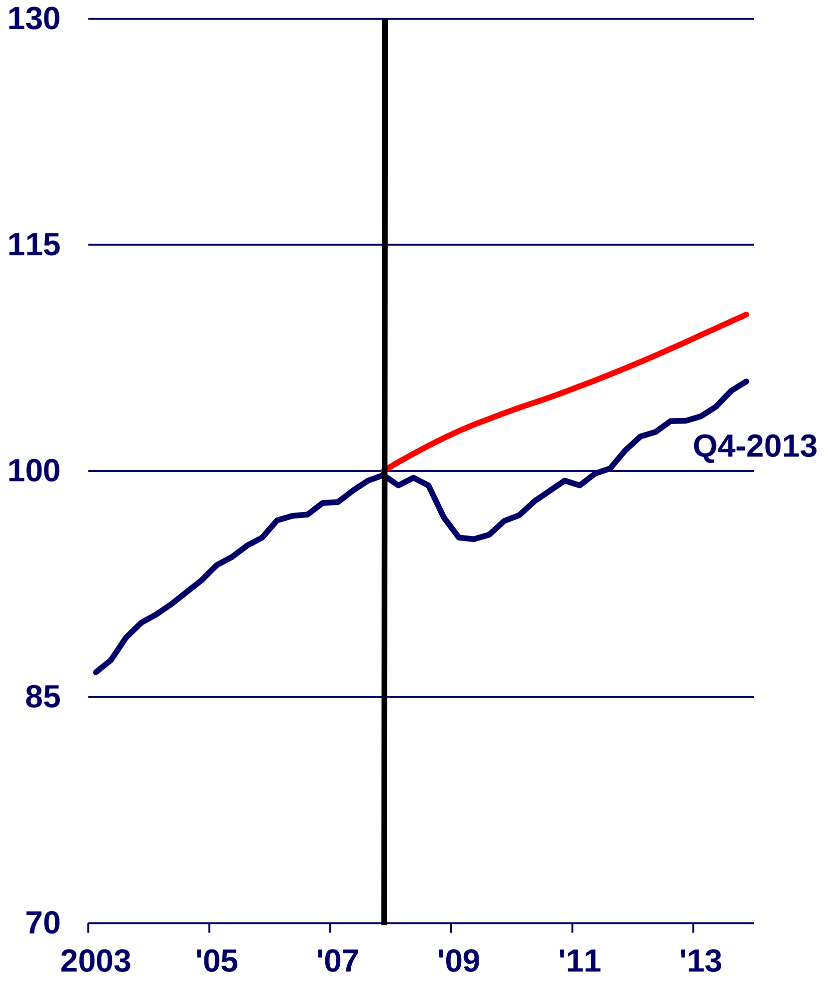
- **Likely to remain near zero "well past" U < 6.5%, especially if projected inflation continues to run below the 2% target.**

Output Gap: 1982 Recovery vs. Today

Actual and Potential GDP: 1982
(1981 Q3 = 100)

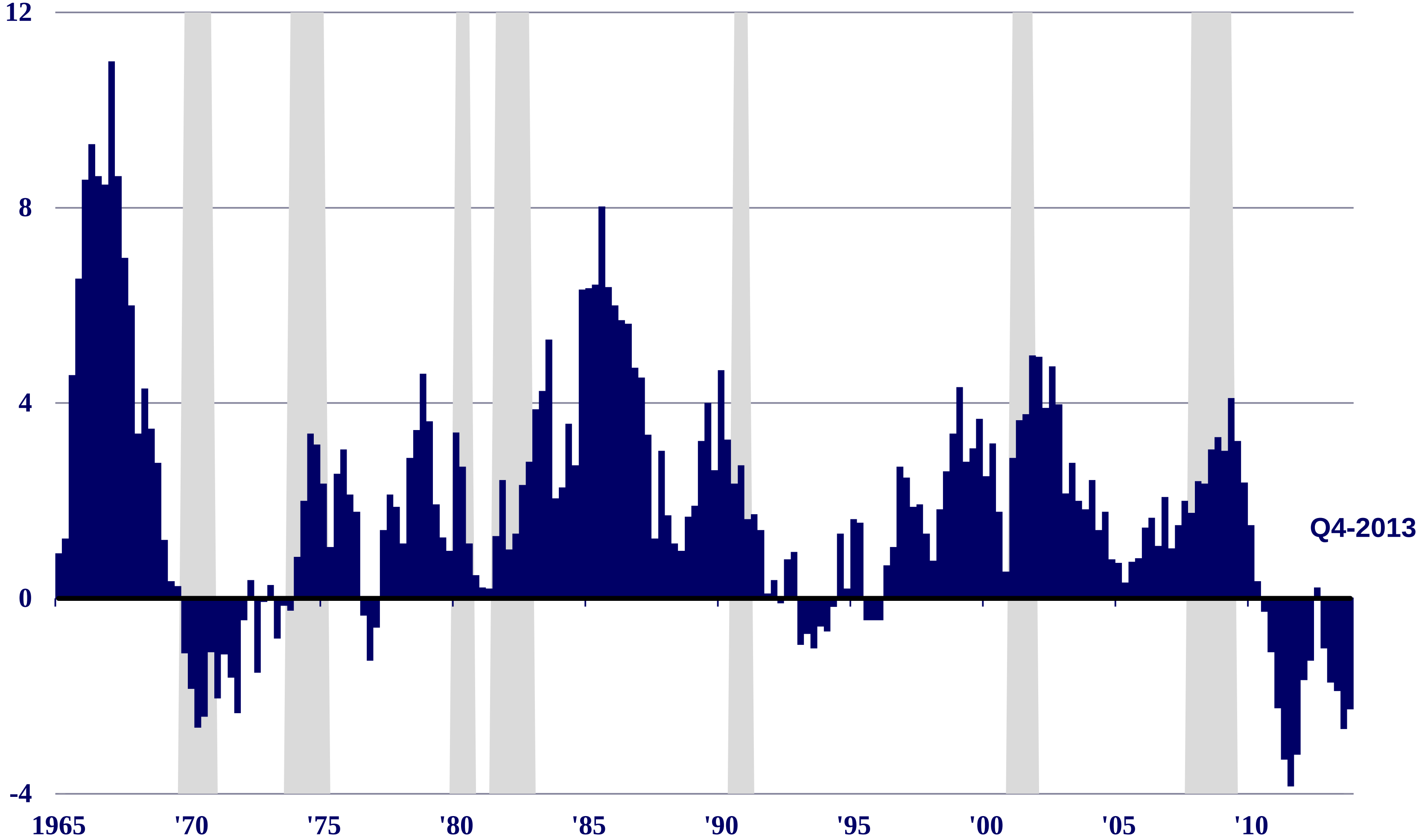


Actual and Potential GDP: 2007
(2007 Q4 = 100)



Fiscal Policy: Historically Unusual

Contributions of Government Purchases to Real GDP Growth
(percent)



Looking Ahead: Exit Principles (June 2011 Minutes)

- **Balance sheet size**
  - Smallest level consistent with efficient monetary policy operation
- **Balance sheet composition**
  - Treasury only
- **Likely normalization sequence**
  - Taper, then end LSAPs
  - Cease reinvestment of maturing securities
  - Begin raising rates and drain reserves
- **New tools: IOER, RRP Facility, term deposits**

Looking Ahead to the Future

- **Balanced approach to deviations from goals**

- **Inflation preferences should be symmetric**

- **Must recognize limitations of monetary policy during episodes in which real cycles dominate**