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The U.S. Economy in the Aftermath of the Financial Crisis

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Four themes

- The FOMC adopts inflation targeting.
- Brighter prospects for the U.S. economy.
- Ongoing problems in U.S. housing markets: A collapsed real estate bubble.
- New policy tools at the Fed.

Inflation Targeting in the U.S.A.

The FOMC sets an inflation target

- At the January 2012 meeting, the Federal Open Market Committee (FOMC) named an explicit, numerical inflation target of 2 percent.
- The Fed joins many central banks around the world in adopting an inflation target.
- Chairman Bernanke's goal since joining the Fed.
- Congratulations to the Chairman on this important accomplishment.

Inflation means headline inflation

- Inflation is measured by the personal consumption expenditures (PCE) price index.
- It is the headline index that is targeted.
 - It does not make sense to ignore some inconveniently volatile prices, like those for gasoline and food.
- Headline PCE inflation measured from one year ago is 2.4 percent, somewhat above target.
 - This measure has been falling in recent reports.

Inflation targeting and stabilization policy

- Inflation targeting emphasizes control over inflation as the key long-term goal of monetary policy.
- The actions of the FOMC can also temporarily influence the direction of the economy in the short run.
 - This influence can help to smooth macroeconomic fluctuations.
 - This is known as monetary stabilization policy.
- An inflation target combined with a sensible stabilization policy is often called *flexible inflation targeting*.
- This is the policy the FOMC has adopted and that follows the practice of many other central banks.

Flexible inflation targeting

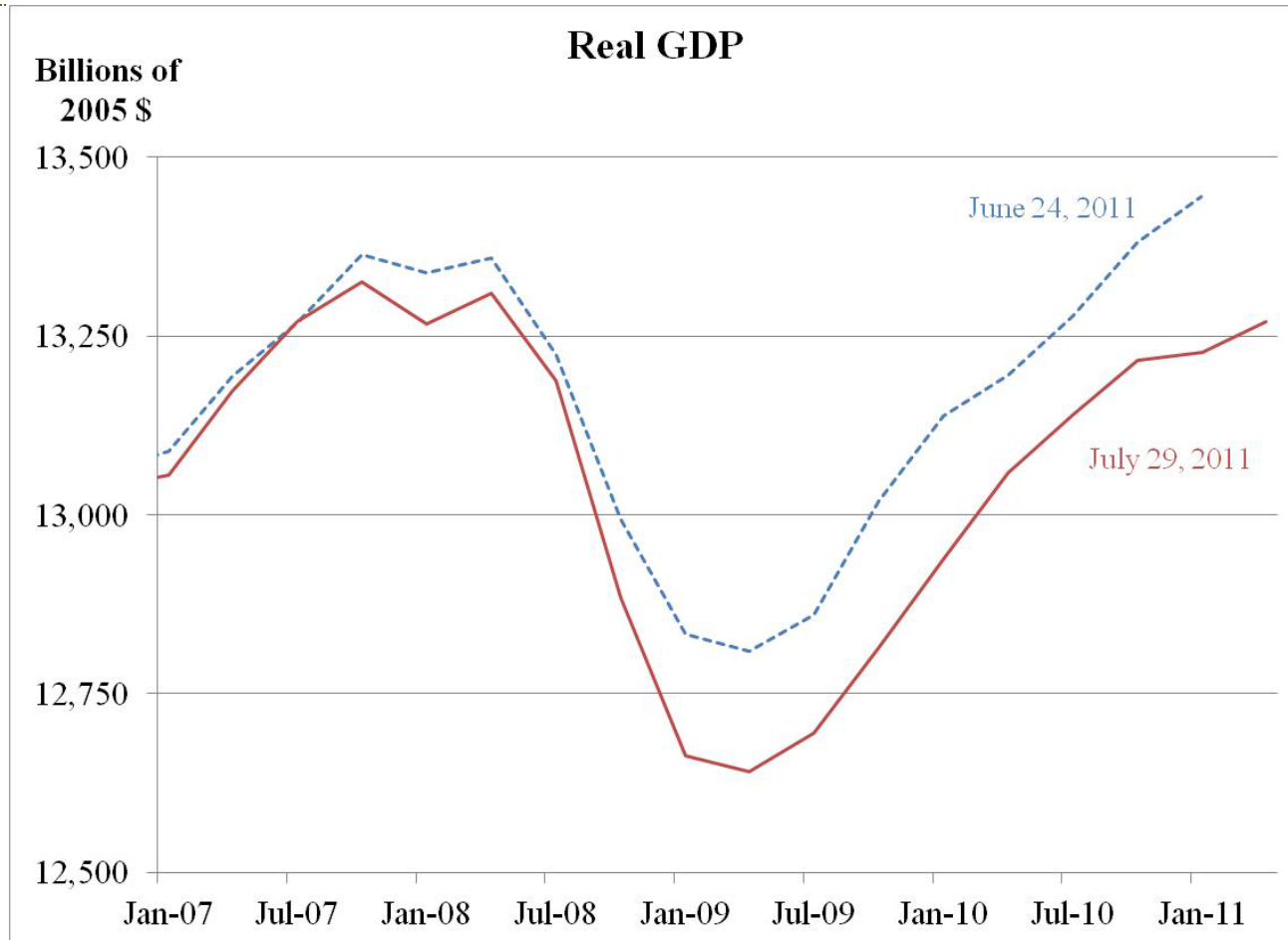
- Flexible inflation targeting enables a central bank to conduct stabilization policy without compromising the longer-run goal of keeping inflation low and stable.
- The 1970s experience with double-digit inflation was accompanied by especially poor macroeconomic performance.
- The lesson: Allowing high inflation just causes problems and does nothing to address fundamental macroeconomic issues.

Brighter Prospects for the U.S. in 2012

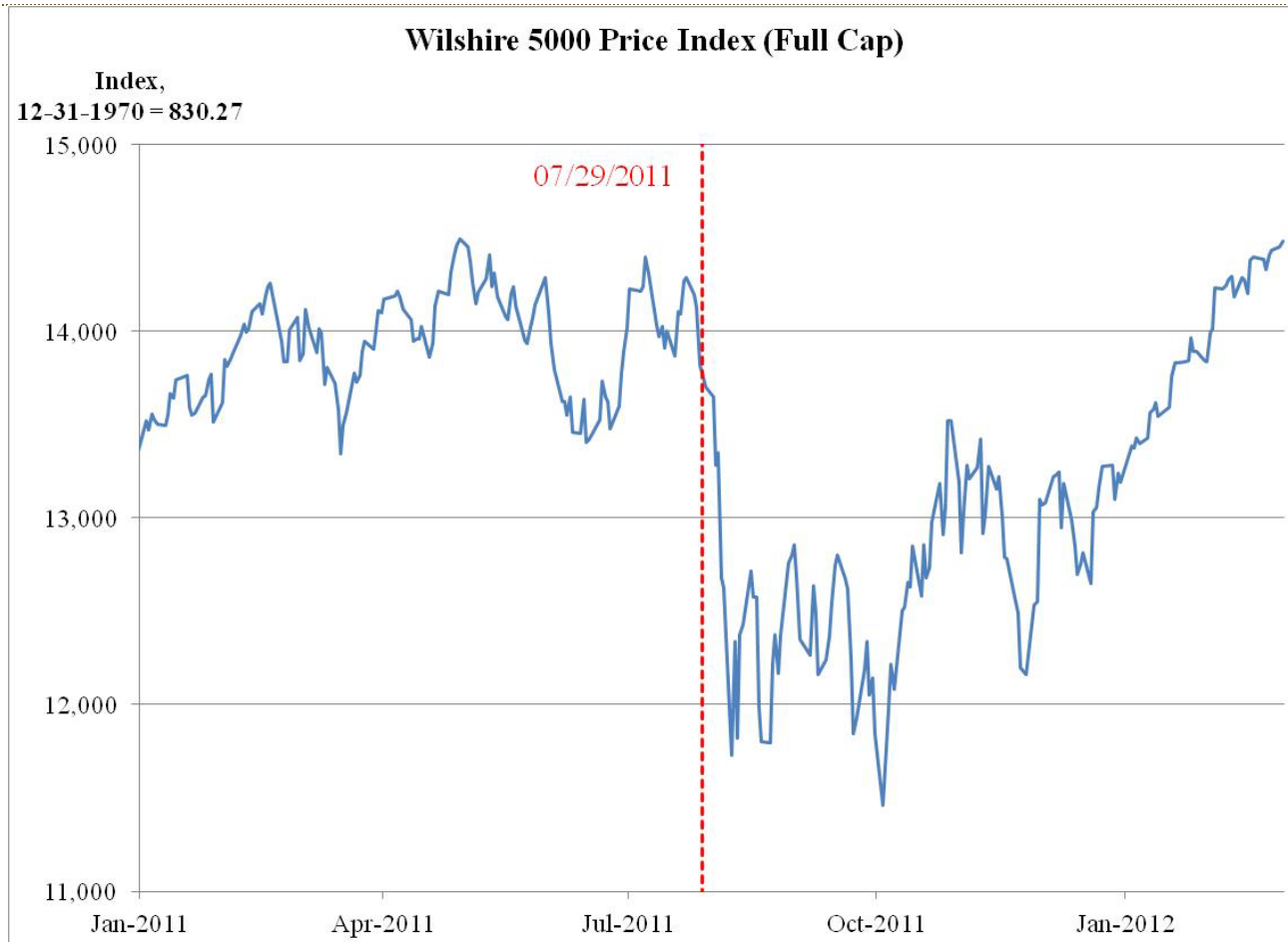
The recession scare

- Last August, forecasters marked up the probability that the U.S. would fall into recession during the second half of 2011.
- Most of this was because of the July 29th GDP report.
- The debt ceiling debate and the European sovereign debt crisis damaged household and business confidence.
- However, household and business behavior did not change by enough to validate the recession predictions.

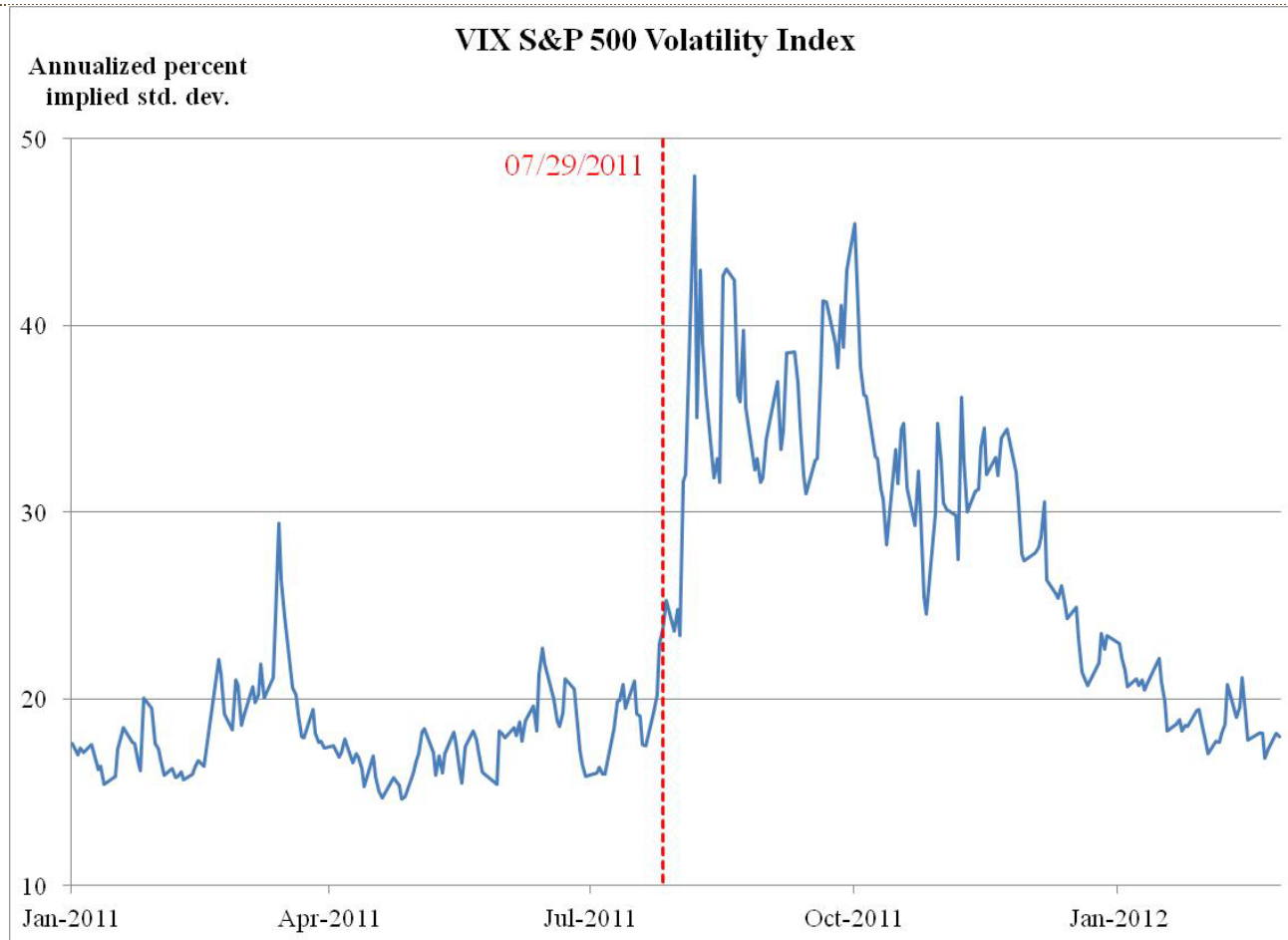
The entire path of GDP marked down



Equity valuations fell sharply



U.S. market volatility increased



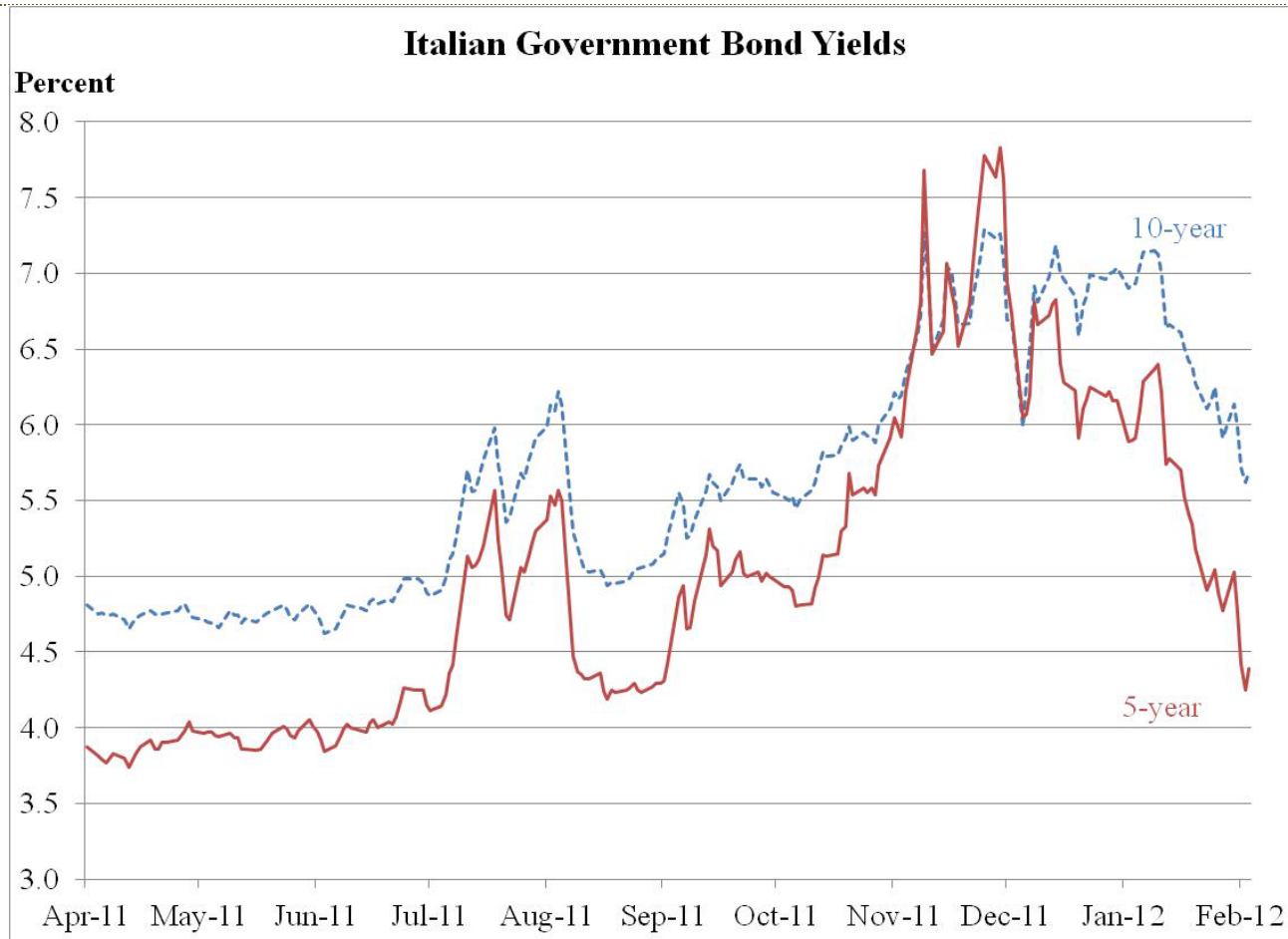
The effects of consumer confidence

- U.S. households remain nervous due to the headlines from Europe, but in general Europe is viewed as too distant to force them to change behavior in a major way.
- So, despite drops in confidence last summer, hard data on the U.S. economy continued to show moderate growth.
- Since last summer, household confidence has increased.

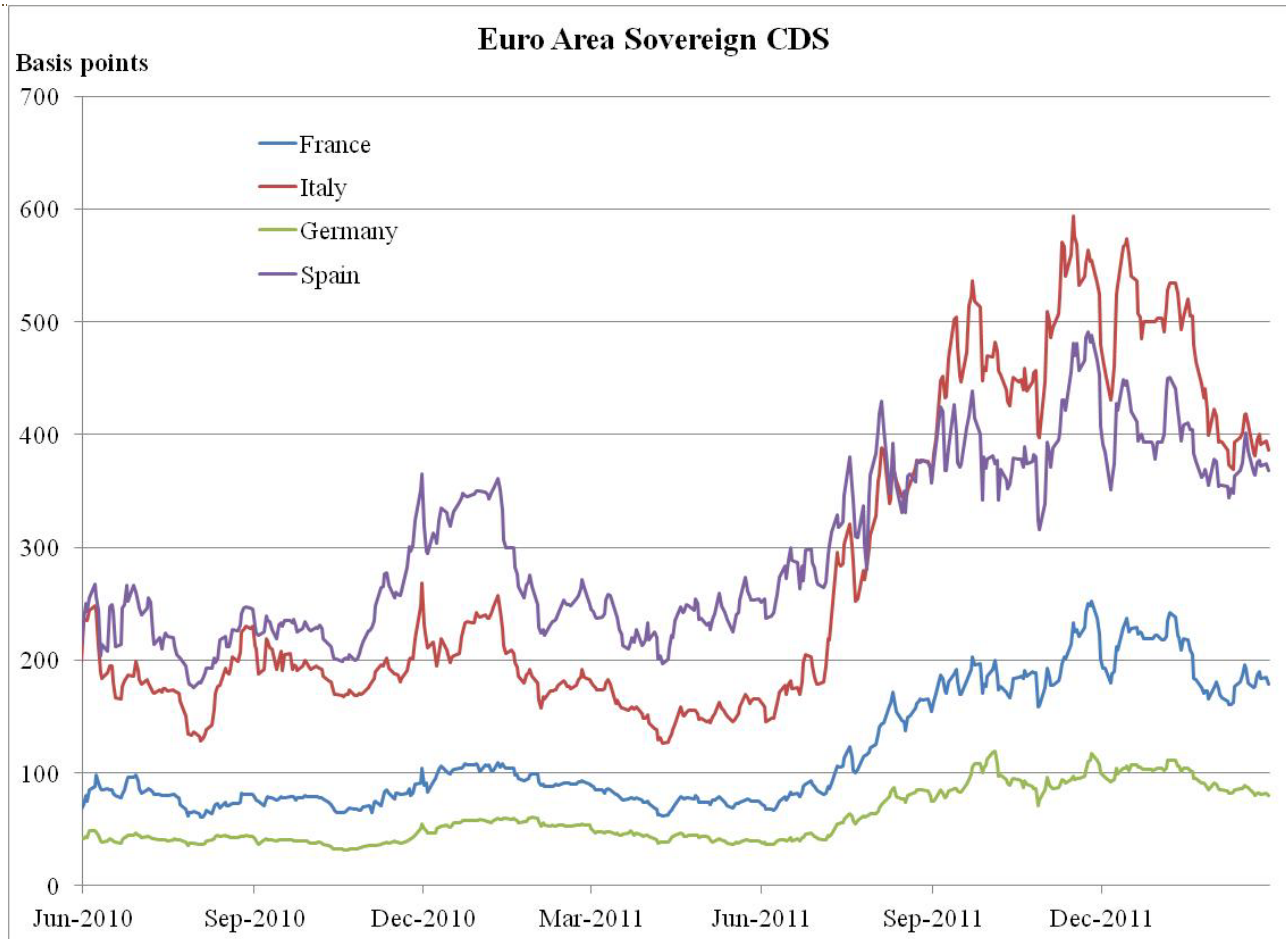
ECB long-term refinancing calms markets

- The ECB offered three-year refinancing at low rates on broadened collateral in December.
- A second tranche, worth about \$713 billion, was offered recently.
- At least for now, this has calmed European markets relative to last fall.

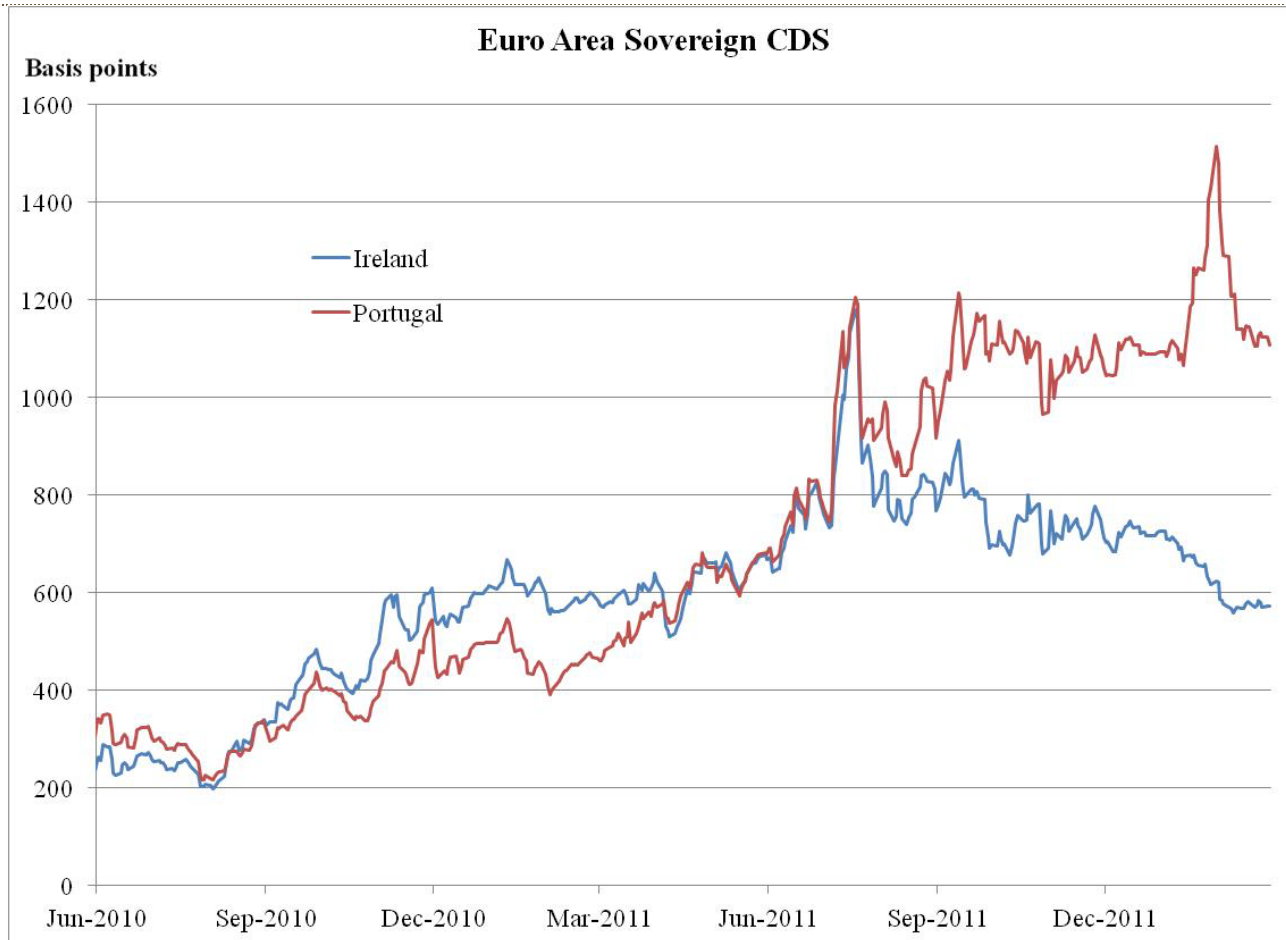
European markets calmer



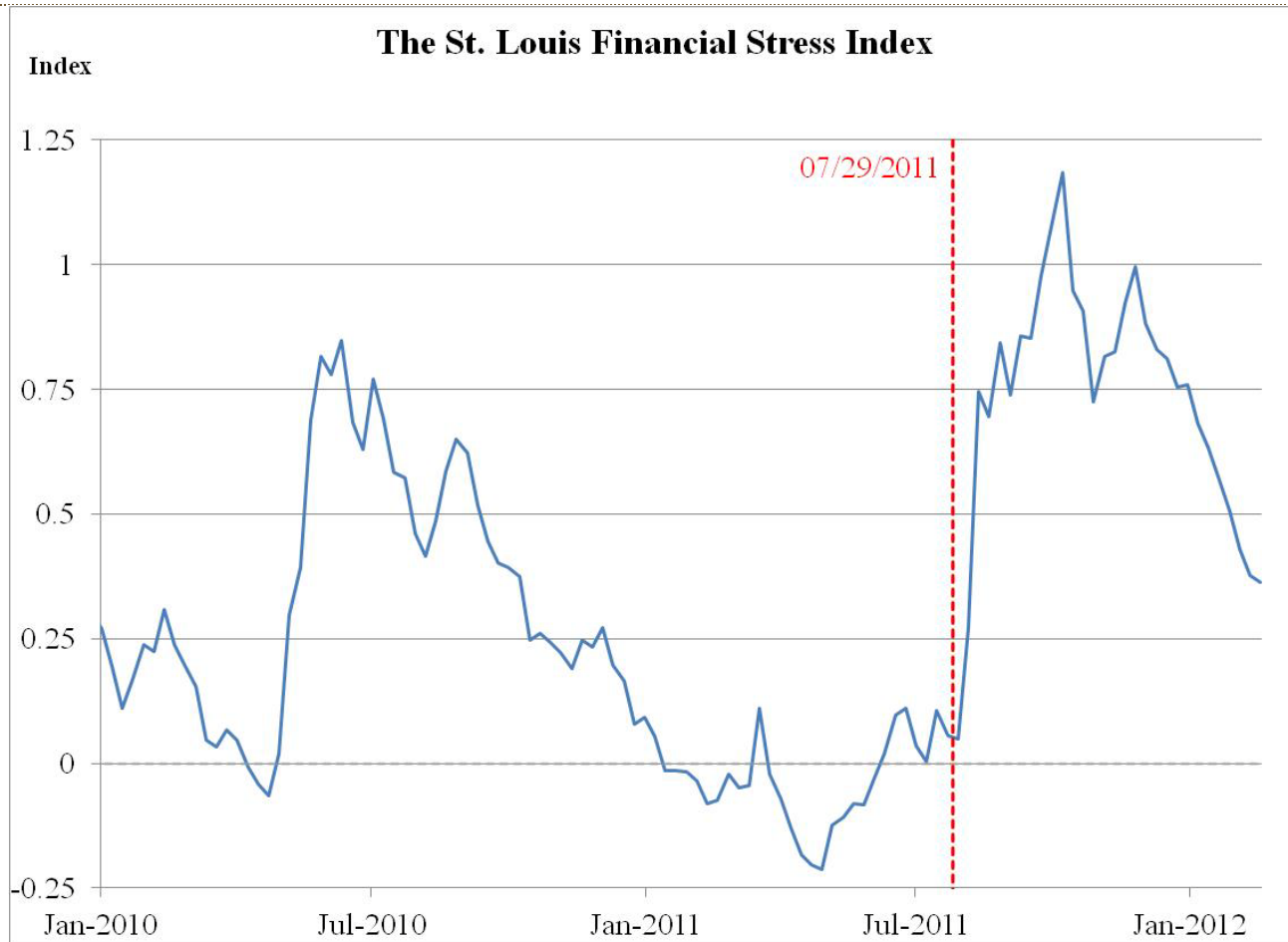
European CDS still elevated



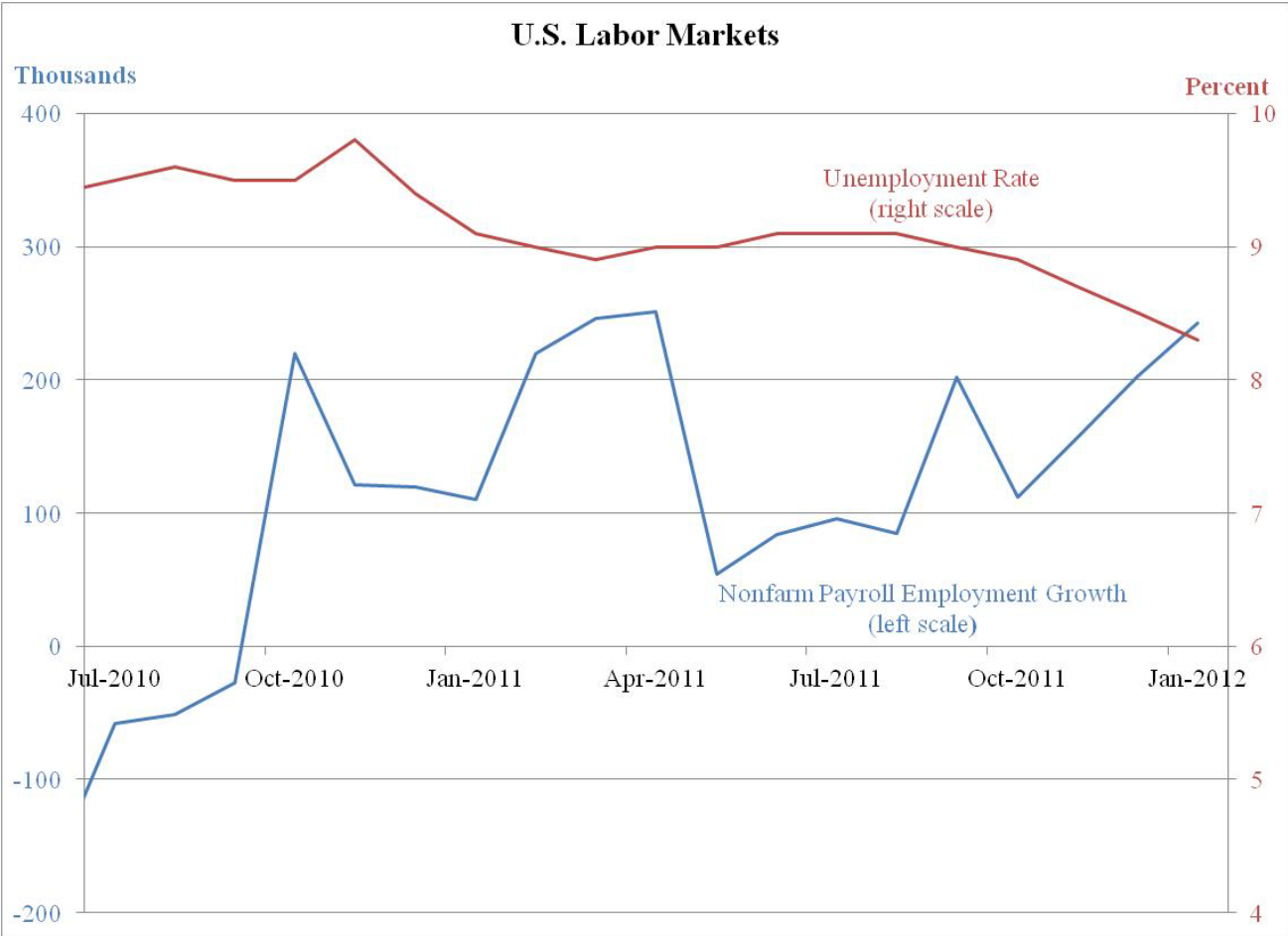
European CDS still elevated



Financial stress falls in the U.S.



Improvement in U.S. labor markets

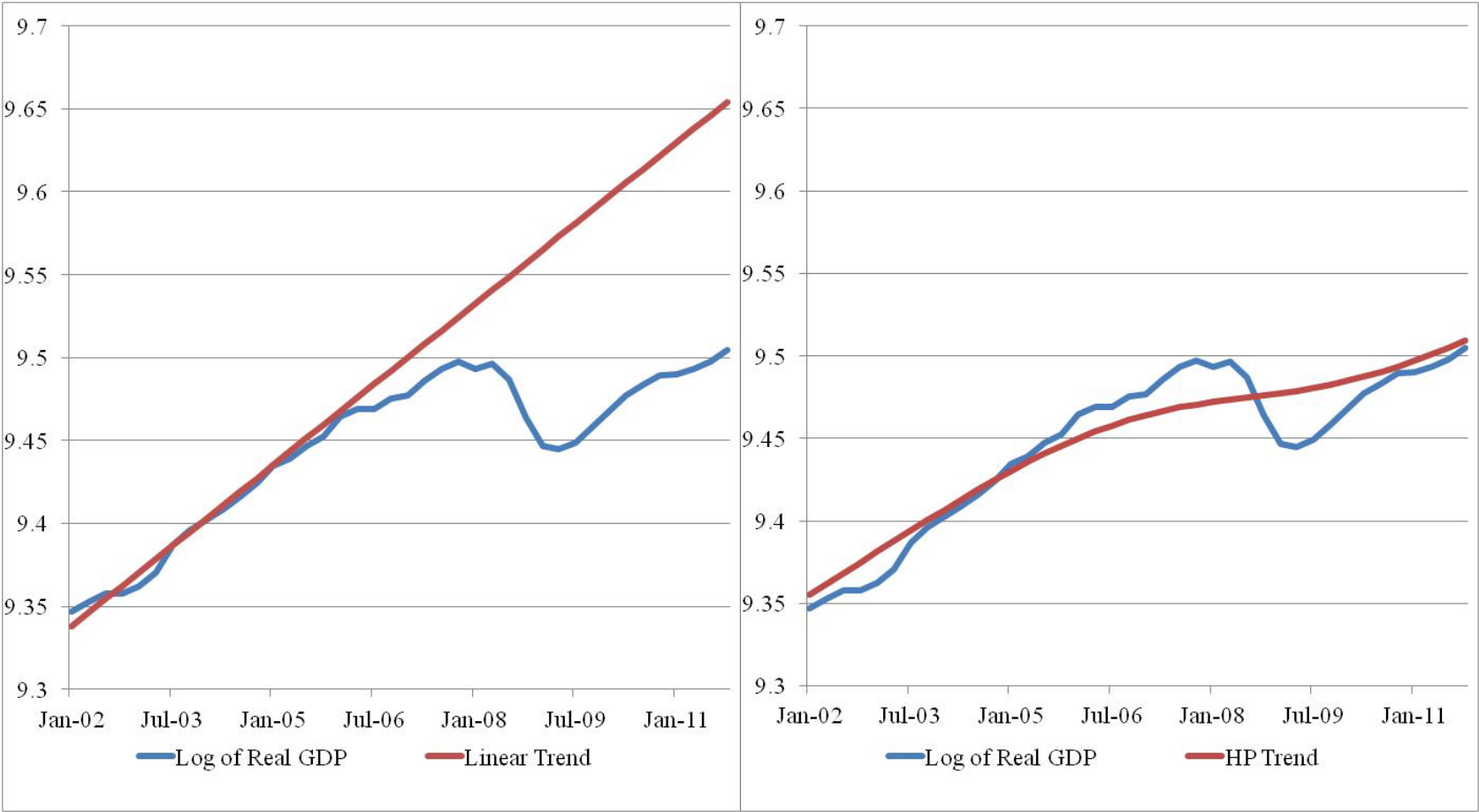


U.S. Housing Markets

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 is therefore not reasonable to claim that the “output gap” is exceptionally large.

Decomposing real GDP



Re-inflating the housing bubble?

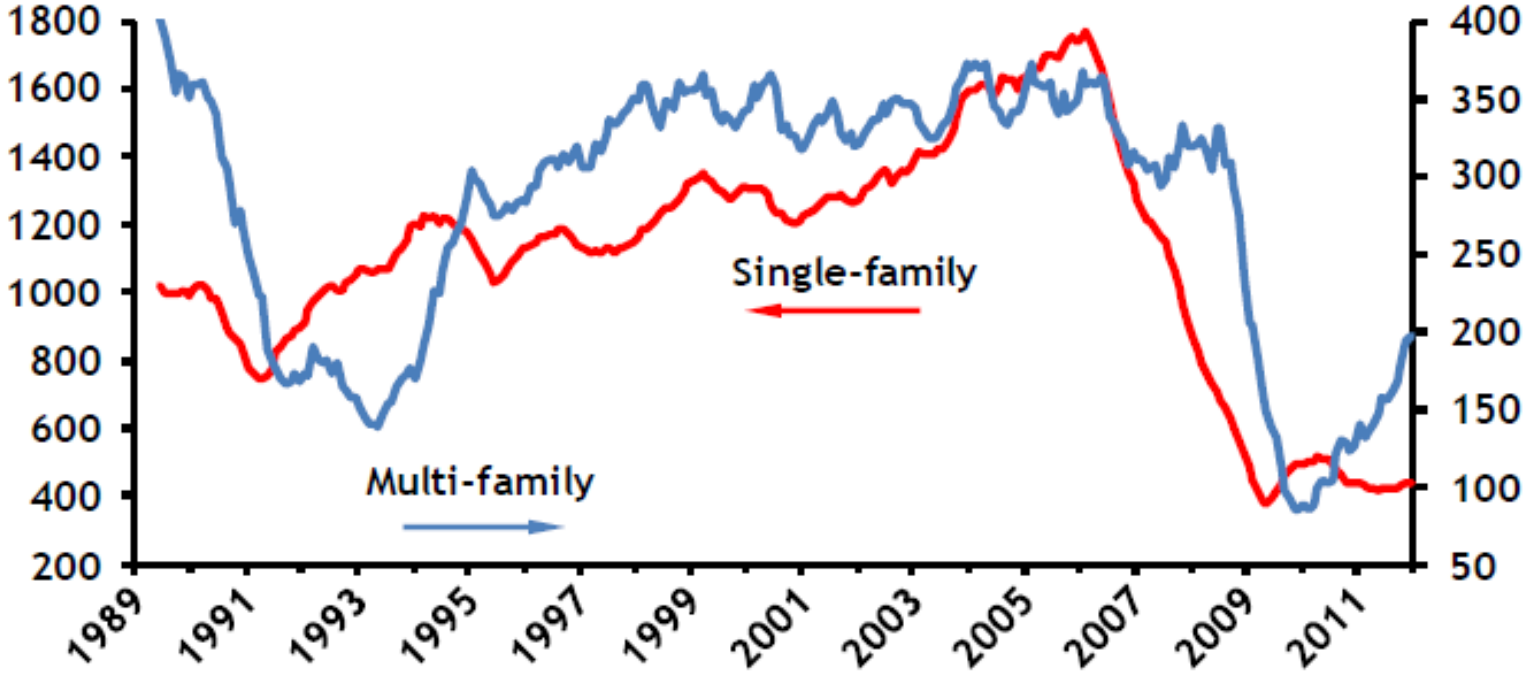
- It is neither feasible nor desirable to attempt to re-inflate the U.S. housing bubble of the mid-2000s.
- The crisis has likely scared off a cohort of potential homeowners, who now see home ownership as a much riskier proposition than renting.

Housing Starts

Chart 9: Housing Starts

Housing starts, single-family and multi-family

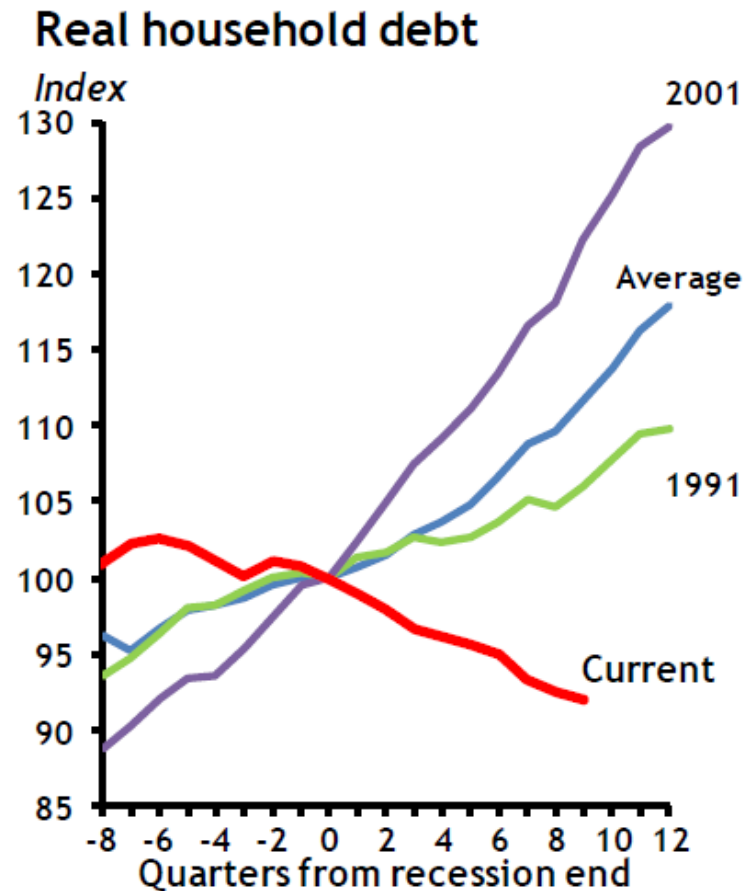
000s saar, 6mo moving avg, both scales



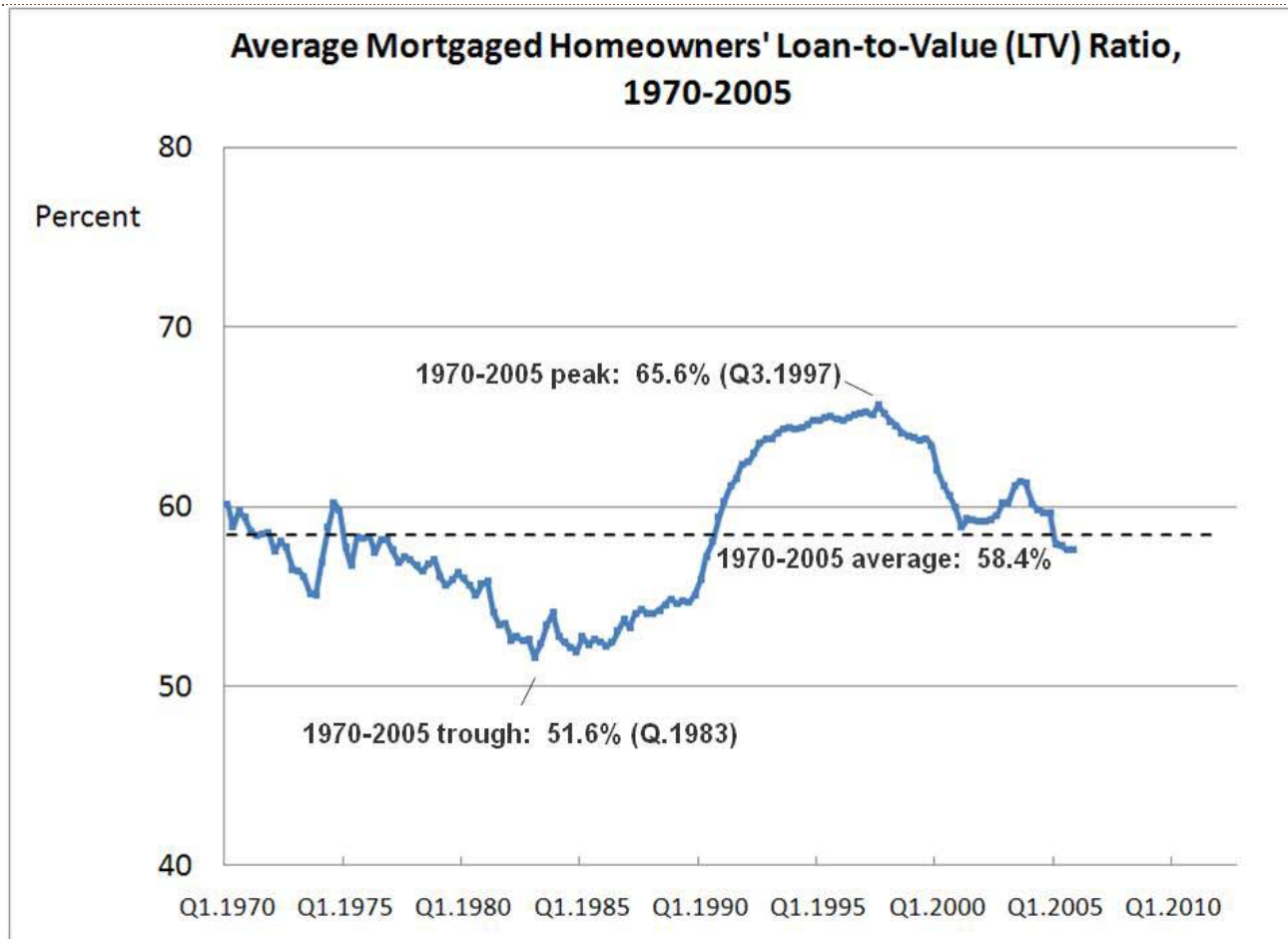
Too much debt

- 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

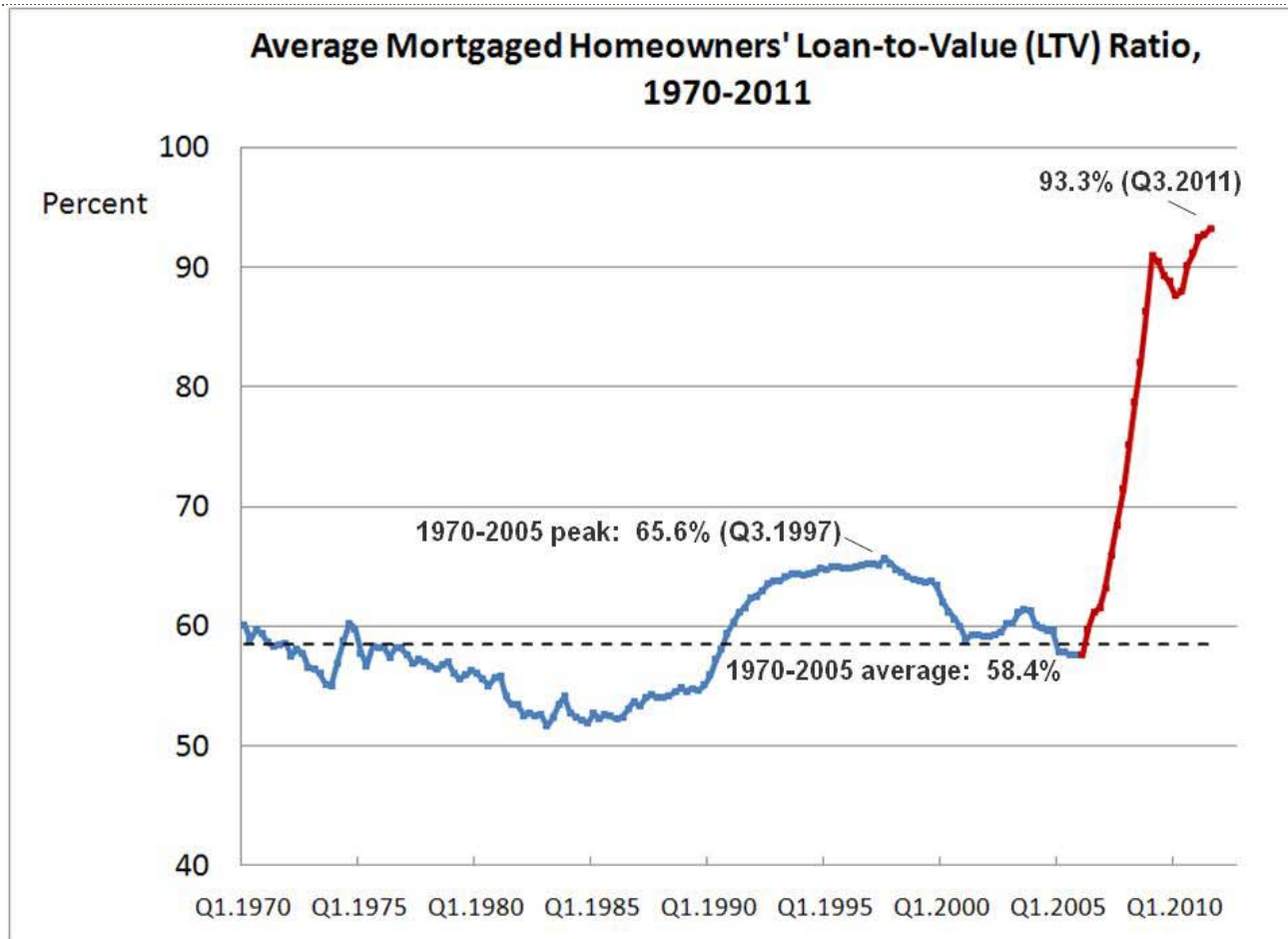


Moderate LTV ratios



Source: Federal Reserve Flow of Funds Accounts and Survey of Consumer Finances; author's calculations.
Last observation: Q3-2011.

... until house prices crashed



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Too much debt

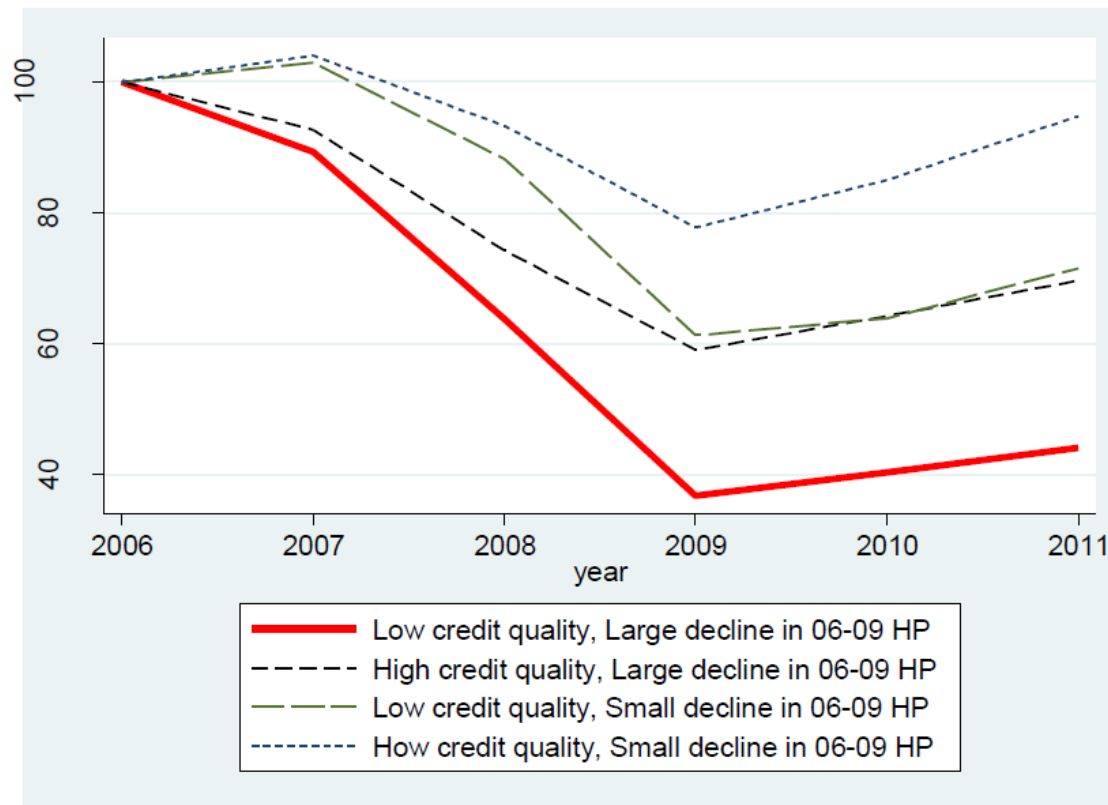
- Suppose we think of 58.4 percent as the “normal” loan-to-value ratio.
- U.S. homeowners have about \$9.9 trillion in debt outstanding against \$712 billion of equity.
- To get back to the normal LTV, households would have to pay down mortgage debt by about \$3.7 trillion, about one-quarter of one year’s GDP.
- This will take a long time. It is not a matter of business cycle frequency adjustment.

Some households are constrained

- Feroli, et al., (2012) suggest that some households may not be able to react normally to easy monetary policy.
- This is because they cannot borrow more against their home values.
- Evidence: States with the largest declines in home values have the weakest recoveries.
- Monetary policy may not be able to reach the constrained households.

Auto sales by state and credit quality

Chart 22: Auto Sales for High and Low Credit Quality within Large and Small House Price Decline States

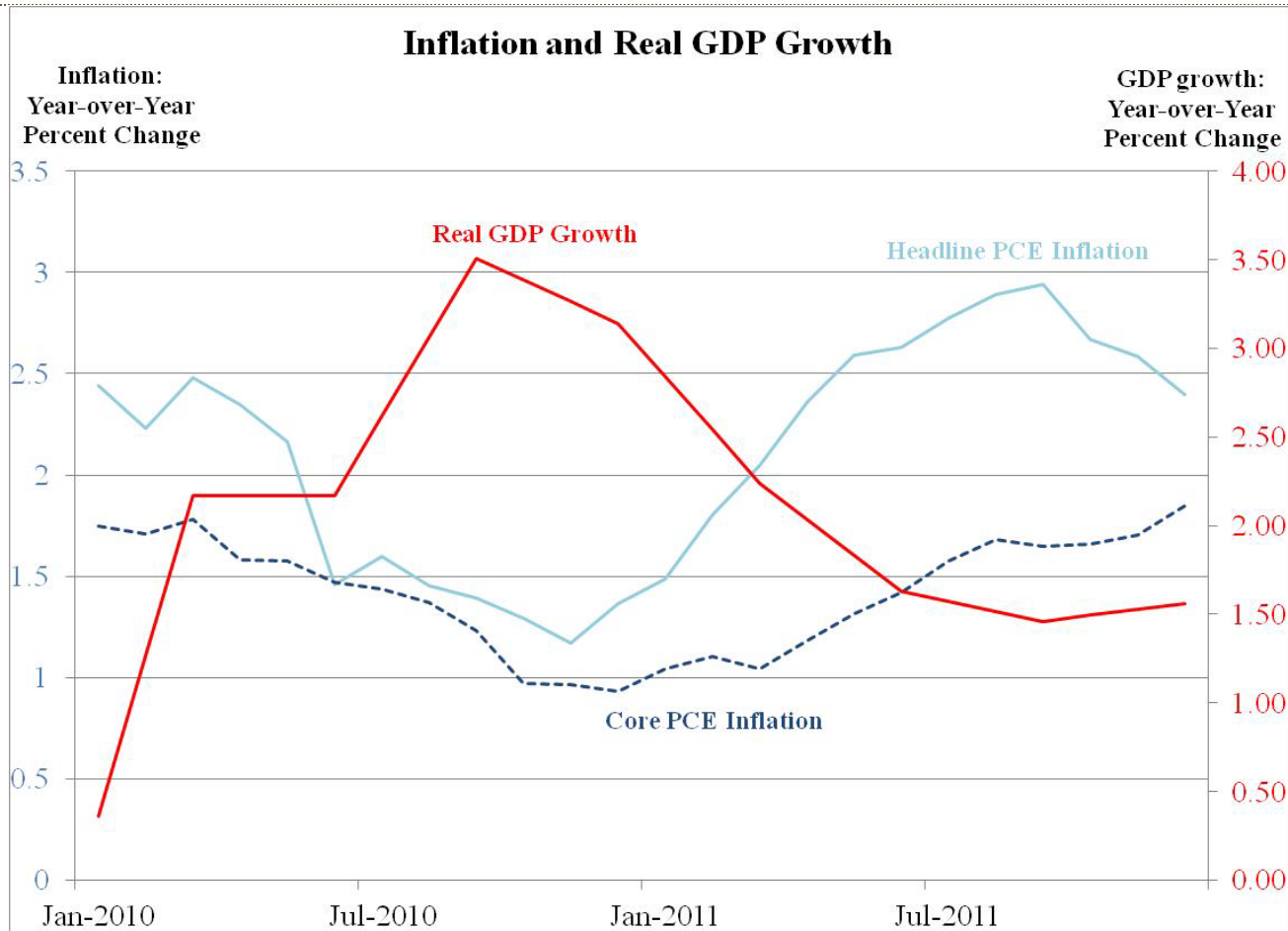


Recent Monetary Policy

Asset purchases

- Increases in the size of the balance sheet entail additional inflationary risks if accommodation is not removed at an appropriate pace.
- Inflation and inflation expectations rose during the last 18 months, even though many measures of economic performance indicate that the U.S. economy was relatively weak.

Inflation turns around



The communications tool

- The Committee could 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 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, 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 be unhelpful.

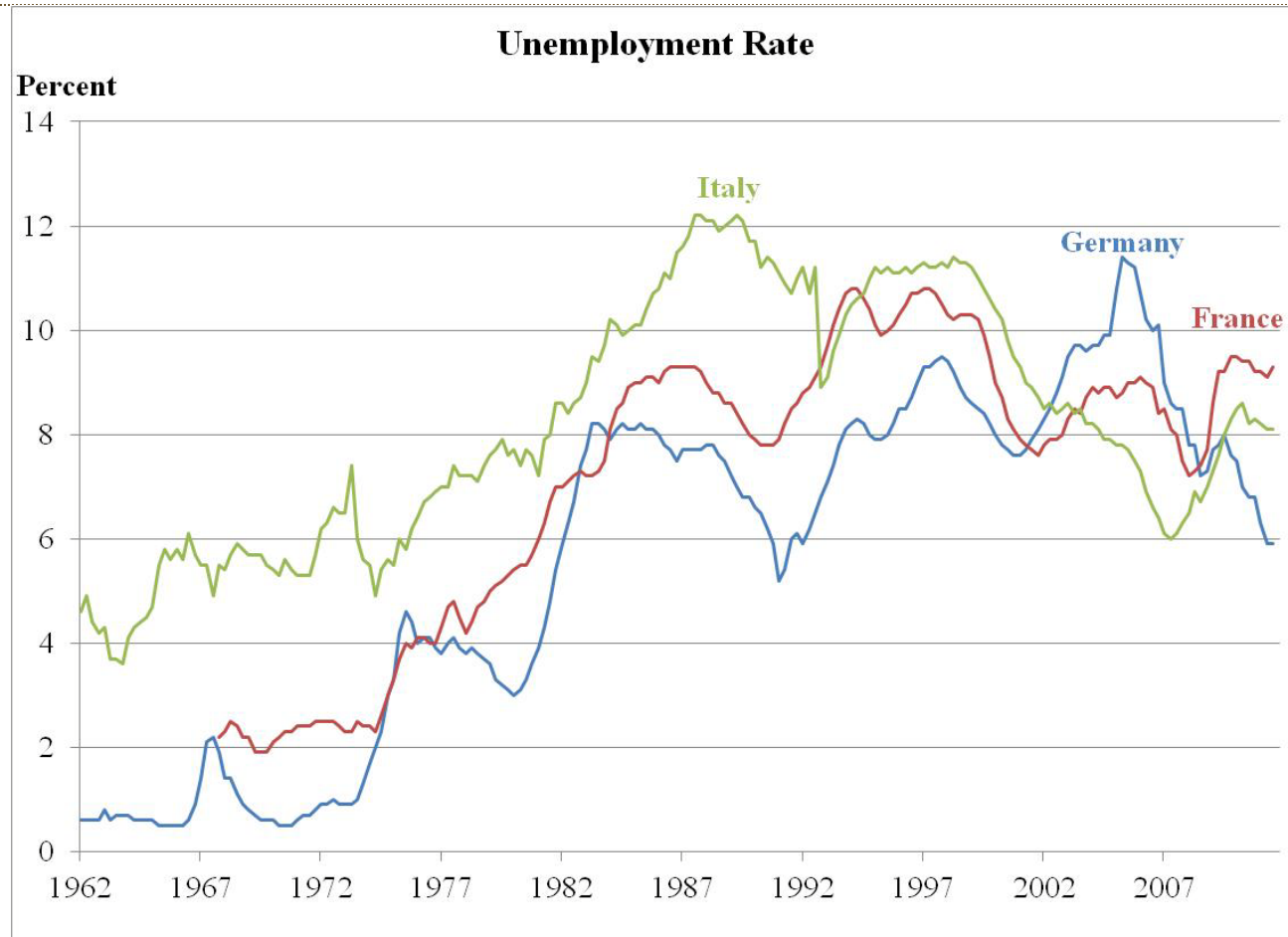
The communications tool: ties to actual outcomes?

- The Committee could also tie a promise of near-zero policy rates to actual outcomes in the economy, such as the unemployment rate.
- Most proposals use an *actual* unemployment rate but an *anticipated* inflation rate.
 - This asymmetry is hard to justify.
- Unfortunately, unemployment rates have a checkered history in advanced economies over the last several decades.

The communications tool: ties to actual outcomes?

- In particular, “hysteresis” has been a common problem—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 tied to a numerical unemployment outcome, monetary policy could be pulled off course for a generation.

European unemployment: hysteresis



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 address unemployment instead of monetary policy.

Conclusions

Recap

- The FOMC adopts inflation targeting.
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