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Monetary Policy and the U.S. Economy in 2012[1]
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Introduction

Macroeconomic prospects in the U.S. are looking somewhat brighter in 2012. This is providing the Federal Open Market Committee (FOMC) with an opportunity to pause in its aggressive easing campaign, to allow the Committee the chance to assess developments in the economy and observe the effectiveness of recent policy actions. This opportunity to pause is quite important because the Committee is taking a substantial, but calculated, risk with the Federal Reserve balance sheet.

To be sure, there have been many policy actions to ease financial conditions in recent years. In January 2008, the Committee sharply and pre-emptively lowered the policy rate as the global financial crisis gathered steam and seemed to be hampering real economic performance. In December 2008, the Committee lowered the policy rate effectively to zero, where it remains to this day. In 2009, the Committee authorized the purchase of mortgage-backed securities. In 2010, in response to a possibly deflationary outlook, the Committee launched QE2, the outright purchase of about $600 billion in U.S. government debt.[2] In 2011, after the completion of QE2, the Committee authorized a modern version of "Operation Twist," in particular, selling $400 billion in short-term Treasuries in exchange for the same amount of longer-term bonds. The Committee also began the use of explicit dates to describe the possible length of the near-zero rate policy. In January 2012, with Operation Twist still in motion, the Committee named an explicit numerical inflation target of 2 percent for the first time, provided more information concerning the individual forecasts of Committee members on key macroeconomic variables, and extended the period of a likely near-zero policy rate to late 2014.

This litany illustrates the determination of the Committee and of Chairman Bernanke to provide support to the U.S. economy in the face of one of the largest macroeconomic disturbances in modern economic history. Indeed, the policy has been successful in the sense that the U.S. has

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[1] Any opinions expressed here are my own and do not necessarily reflect those of others on the Federal Open Market Committee. I thank my staff for helpful comments.
[2] These policies have more than tripled the size of the Fed's balance sheet since September 2008.

not slipped into the scenario of a falling price level, which sometimes occurs after shocks of this magnitude.

But now, with the Committee on pause, it may be a good time to take stock of whether we may be at a turning point. 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, those policy actions may create an overcommitment to ultra-easy monetary policy. The ultra-easy policy has been appropriate until now, but it will not always be appropriate.

The FOMC has often been criticized historically for overstaying policy stances that might have made sense at one juncture but are no longer appropriate as macroeconomic conditions change. This occurs in part because of the lags in the effects of policy, the difficulty in interpreting real-time data, much of which is subsequently revised, and the sheer uncertainty of macroeconomic developments. With numerous monetary policy actions still on the table, and others still affecting the economy with a lag, it may be especially difficult to remove policy accommodation at the appropriate pace and at the appropriate time. One may want to approach such a situation with caution.

Brighter Prospects

The U.S. economy may achieve 3 percent growth in real GDP in 2012. This is not a high growth rate by historical standards in the U.S., but the outlook has improved markedly compared to last summer. As many of you know well, during August 2011, the U.S. macroeconomic outlook deteriorated significantly to the point where many observers were worried that the U.S. economy would move into a recession state. The U.S. avoided the recession outcome, but I think it is instructive to remind ourselves of this period and what has changed since then.

There were many cross currents at play during the recession scare. One was the ongoing adjustment to the tragedy in Japan, which disrupted supply lines and altered production schedules significantly during 2011. Another was the debate in the U.S. Congress concerning the debt ceiling. The European sovereign debt crisis was entering a new, more difficult phase, with Italian debt yields in particular rising sharply. And in the middle of these important developments, on July 29, the U.S. GDP data for the previous several years was marked down sharply. The data revisions suggested that the U.S. recession of 2008 and 2009 was deeper than previously understood, and that the recovery was weaker. When forecasters put the new

data into their models, the result was a sharply lower profile for U.S. growth during the second half of 2011 and continuing on into 2012. This, combined with the other factors, seemed to suggest that recession probabilities had increased dramatically.

As it turned out, the U.S. was not on the precipice of recession last summer. U.S. GDP growth was stronger in the third quarter compared to the first half of 2011, and improved further during the fourth quarter of the year. What changed?

Certainly much progress occurred in restoring supply chains and production schedules in the aftermath of the tragedy in Japan. In addition, a temporary fix for the U.S. debt ceiling problem was agreed upon. However, in my view, the most important factor has been the reduction of tensions in global financial markets. Two important contributors to reduced stress have been the introduction by the European Central Bank (ECB) of the Long-Term Refinancing Operation (LTRO), and the relatively successful navigation of Greek debt restructuring. In response to these developments, global financial markets have, at least for now, substantially marked down the probability of a significant financial crisis in Europe.

The ECB's LTRO program has substantially increased the size of the ECB's balance sheet. The ECB's lending program to European banks is based on an expanded set of collateral criteria. While most central bank lending is viewed as temporary, this funding program continues for three years and could in principle be extended depending on macroeconomic conditions in Europe in the future. This seems to indicate that the ECB balance sheet will remain at a high level for a considerable period of time. One way to view this is that monetary conditions in Europe have become substantially easier in the wake of the LTRO program.

While easier monetary conditions have helped change the climate in global financial markets, fundamental problems remain. Too much borrowing and spending on the part of sovereign governments cannot be repaired by such actions. Debt problems are acute, and only resolute action to better match national revenues with expenditures will allow nations to avoid the fate of Greece.

This applies to the U.S. as well, where most difficult decisions with respect to budgets, taxes and debt have been delayed until after the 2012 elections in November. I remain concerned that financial market uncertainty about possible fiscal actions after the election might derail the U.S. economy during 2012.

Okun's Guideline

Part of the improvement in the U.S. macroeconomic outlook has occurred in labor markets. Unemployment has declined to 8.3 percent, and the latest figures on growth in nonfarm payroll employment have been encouraging.

The unemployment declines have been viewed by some as a puzzle. In 2011, a year of lackluster economic growth, U.S. unemployment declined fairly substantially. This would seem to violate "Okun's law," which suggests that economic growth has to be reasonably robust before the unemployment rate will decline. This is, in fact, the source of some statements in financial markets and elsewhere that the pace of economic growth in the U.S. is too slow to meaningfully improve labor markets.

Yet labor markets have indeed improved, so what's going on? Probably the most important consideration is that—as in the film "Pirates of the Caribbean"—Okun's "law" is not so much a law but more like a "guideline."

Another consideration is that Okun's guideline is not as linear as it is often made out to be. A look at the time series of U.S. unemployment since the mid-1980s indicates that recessions are definitely times when unemployment increases sharply, while expansions are times when unemployment declines slowly. In other words, the relationship between unemployment and GDP growth is very sharp during downturns, but more muddled during expansions. This might suggest that the nation does not need rapid growth to see a reduction in unemployment—it only needs to see some positive growth.

Trend Output in the U.S.

While unemployment has moved in surprising ways in the last year, so has another variable: inflation. Inflation in the U.S. has moved higher from its lows during the fall of 2010. Headline consumer price index and headline personal consumption expenditures inflation, measured from one year ago, are both above the Committee's inflation target of 2 percent. Both have been moderating in recent reports. But because inflation increased during a period in which real economic performance was not stellar, it may be that the output gap is smaller than commonly estimated.

The idea that the output gap—somehow measured—is large, is one of the defining features of many arguments for continued extraordinary monetary policy in the U.S. And, to be sure, the

macroeconomic shock that the U.S. suffered along with the rest of the world in 2008 and 2009 was very large, and the corresponding monetary policy actions have also been large and aggressive, as I outlined in the introduction to this talk.

But the features of some output gap estimates do not seem to correspond with reality. Many estimates suggest that in the fourth quarter of 2007, the quarter during which the recession began in the U.S., output was only just at potential instead of above potential. And many estimates of potential are essentially indistinguishable from linear extrapolations of 2007:Q4 into the indefinite future. By that metric, the U.S. output gap indeed remains large. However, I do not think that is a reasonable metric. Not even close.

The U.S. economy suffered through what is commonly called a housing bubble during the mid-2000s. That bubble burst. Housing prices in the U.S. now appear to have been far too high during the mid-2000s, driven by the widespread belief that “house prices never fall.” When house prices finally fell by 30 percent or more in many areas, the widespread belief was shattered. Households were left with debt levels much higher than they intended to take on, and other areas of the economy—including finance, construction and transportation—were significantly affected. It is neither feasible nor desirable to re-inflate such a damaging bubble.

Our normal measures of potential output do not have any concept of such a “bubble.” In effect, the typical measures simply take all of the upside of the housing bubble on board, calling that the normal level of output to which we should aspire. That is nothing less than a call to re-inflate the housing bubble. But the housing bubble will not return unless the widespread belief that “house prices never fall” returns. With house prices in the U.S. down 30 percent in the aggregate and unlikely to rise very much, it seems quite unlikely that the U.S. housing bubble will re-inflate.

What should we do about this issue, since conventional metrics do not make any allowance for the housing bubble? I suggest using available theory to separate trend from cycle in an appropriate way. Absent that, I suggest using a Hodrick-Prescott filter that removes trends and leaves business cycle frequency movements in the data. Such a filter suggests that the U.S. output gap today is much smaller than commonly believed.

Dealing with the output gap issue is a delicate matter. The discussion today has an eerie 1970s feel to it, in which many argued that the output gap was large and that monetary policy had to remain very aggressive to close the gap. The result was a global inflation debacle that took several decades to completely contain. Some say that if inflation increases, then we know how

to combat it. That is true, but the hard-learned lesson of the 1970s was that if the inflation genie is let out of the bottle, it can be extremely difficult to get it back into the bottle.

Fed Communications

At its January meeting, the FOMC extended the date at which it currently expects to move the policy rate off zero to late 2014. The FOMC also for the first time released individual projections of the future policy path considered best for the economy.

One important lesson from these projections is that the uncertainty surrounding the future policy path is profound. Some policymakers thought it might be necessary to raise interest rates within the next one or two years, while others thought the increase could be postponed for many more years. The confidence interval surrounding the date of the first interest rate increase is so wide it has to be expressed in years.

This very wide confidence interval may seem stunning, but I think in a way it is not surprising. If we know one thing about the U.S. economy, we know that it can behave in unpredictable ways. The amount of uncertainty surrounding U.S. economic performance is profound, and attempts to project macroeconomic outcomes more than 6 to 12 months into the future are unlikely to meet with much success. The amount of uncertainty attached to a projection of U.S. economic performance into 2014 reinforces the idea that much will change between now and then, and that policy will have to change as well to meet new macroeconomic conditions.

The forecasts themselves by the individual members of the FOMC are a step forward for Fed transparency. Chairman Bernanke has led the way toward more and more transparency for the U.S. central bank. This is a definite improvement in Fed communications.

However, despite this improvement, I believe the projections will have to be done differently at some point in the future. The notion of individual forecasts for Committee members is not the most convenient method of conveying information to interested observers. The forecasts as they stand are merely projections of a few macroeconomic variables instead of a more fulsome discussion of all aspects of the U.S. economy. The policy assessments are for the policy rate only, in an environment where balance sheet policy has taken center stage.

I think the Committee should consider publishing a Monetary Policy Report similar to those put together on a regular basis by other central banks. This would be a single report of the staff, containing a longer and more comprehensive discussion of the state of the U.S. economy and

the likely direction going forward. The policy assumption should be the market expectation at the time the report is put together. Such a report would allow commentary on aspects of macroeconomic performance that are unlikely to ever be addressed through a mechanism like the current Summary of Economic Projections.

The more fulsome discussion of macroeconomic developments that would be part of a U.S. Monetary Policy Report would also help with another issue, which is how the Committee might better convey how it might react in future states of the world. Since there are many such future states, it may be misleading to try to delineate how the reaction might occur through the use of a few variables or simple "thresholds." Such a simple description would likely set up an expectation that the Committee would act if a threshold was crossed, when no such expectation was intended or desired by the Committee. A full discussion in a report could lay out these nuances in a way that could be better digested by markets.

Conclusions

The FOMC is currently on pause. At the March meeting, the Committee updated its assessment of the economy, but otherwise left the policy statement largely unchanged.

The Committee has, as I discussed at the outset, pursued an aggressive easing strategy over a period of several years. This strategy seems to have been the right one so far, but it will not always be the right strategy. Some of the further actions that could be undertaken at this juncture would have effects far into the future, in an environment of continual improvement and repair for the U.S. economy. The ultra-easy policy has served us well in a difficult environment, but overcommitting to the ultra-easy policy could well have detrimental consequences for the U.S. and, by extension, the global economy.

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