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The U.S. Macroeconomic Situation and Monetary Policy

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The U.S. macroeconomic outlook

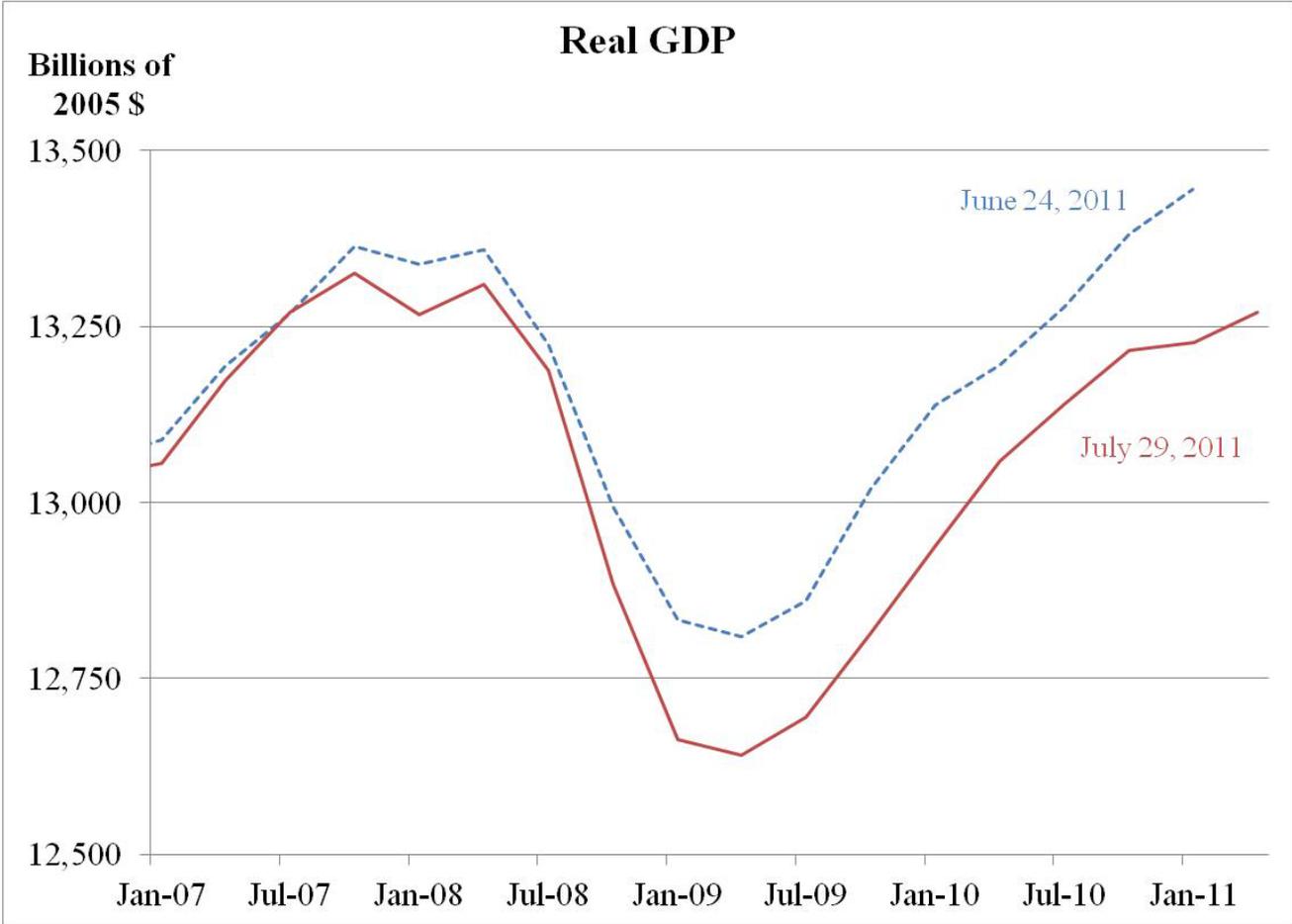
- The U.S. economy has avoided the “recession scare” of last August.
- The FOMC has warned about “substantial downside risks,” mostly emanating from Europe.
- Tying monetary policy directly to unemployment is unwise.

The Recession Scare

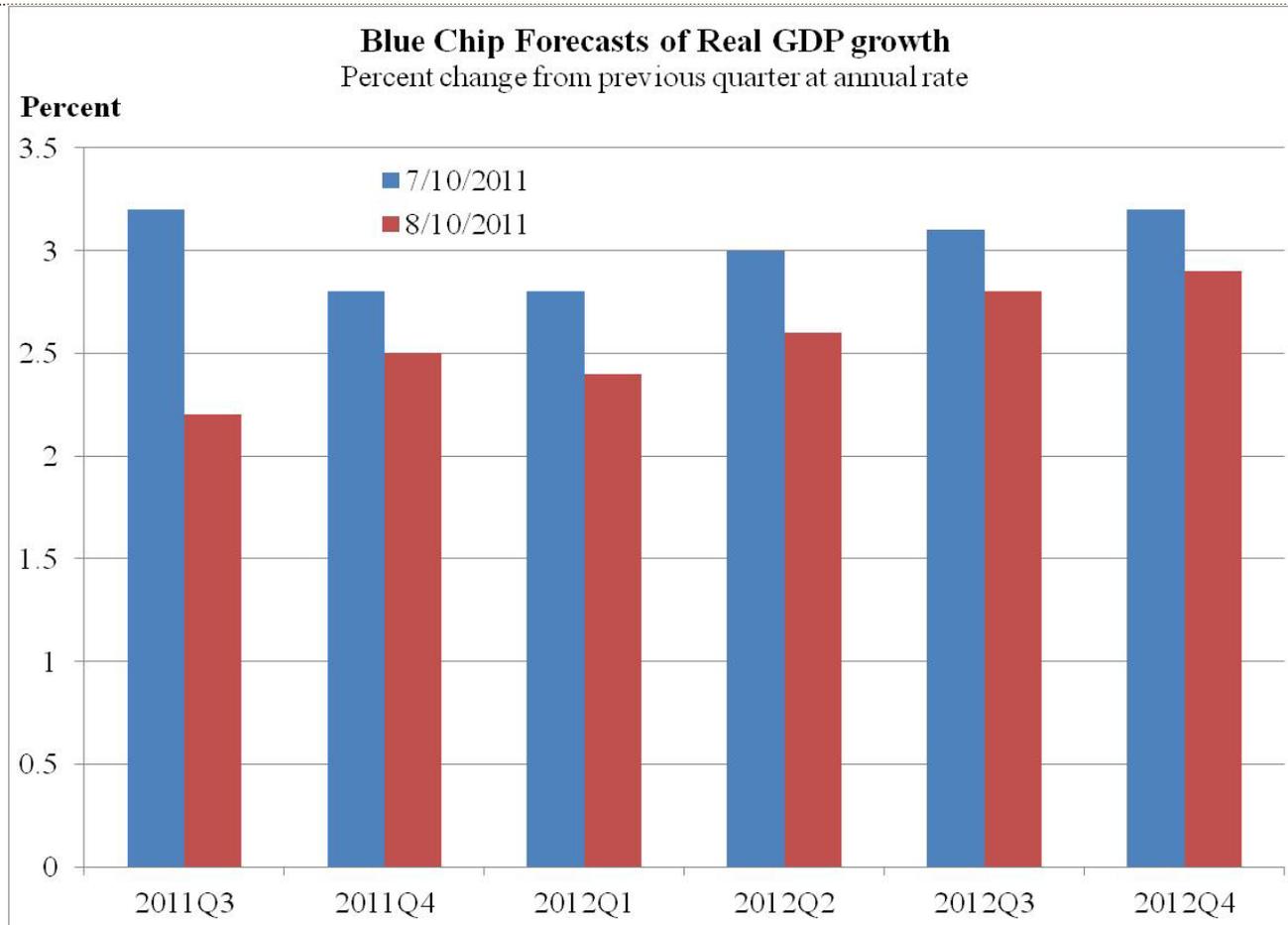
The recession scare

- In 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.

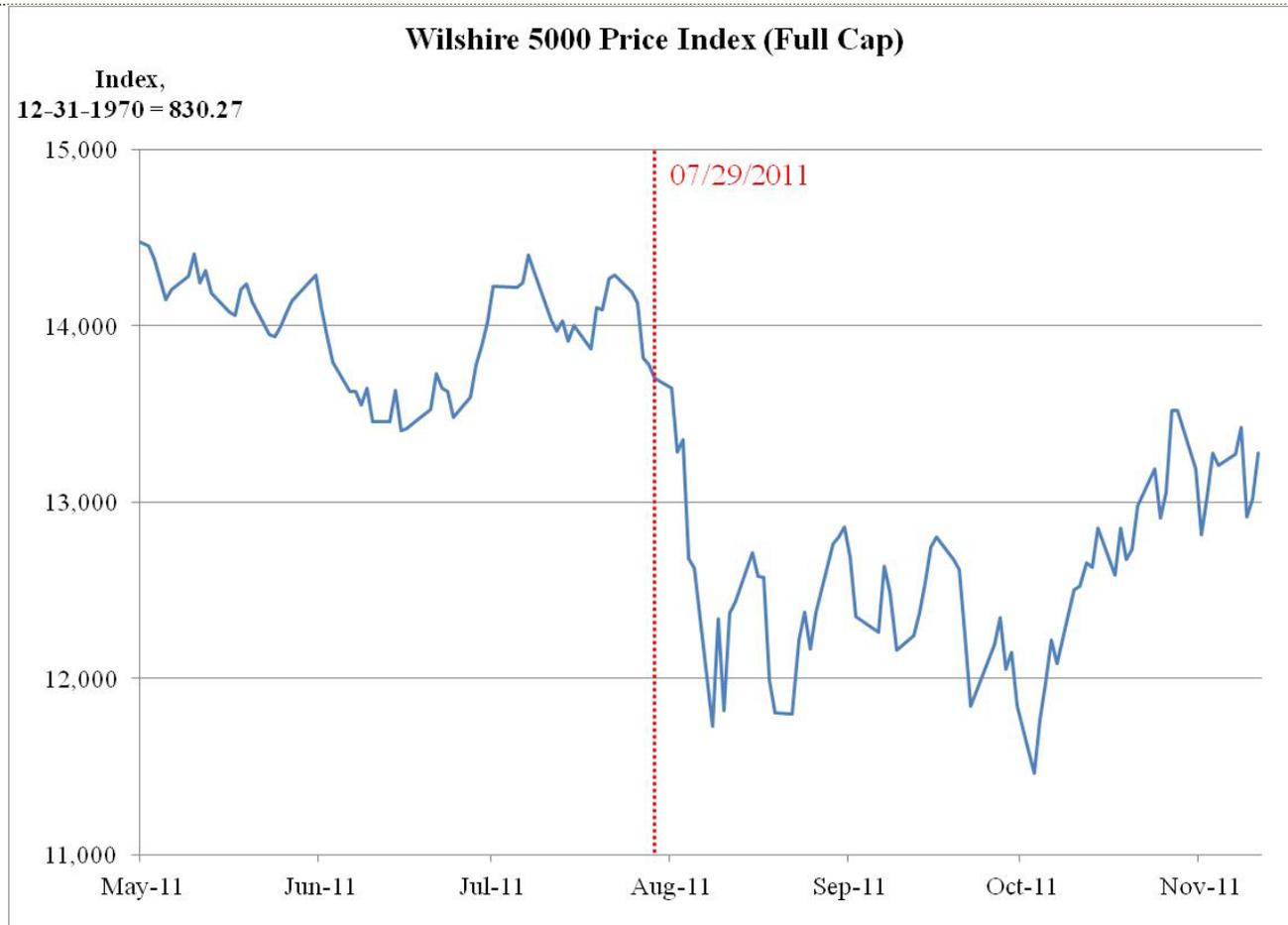
The recession scare



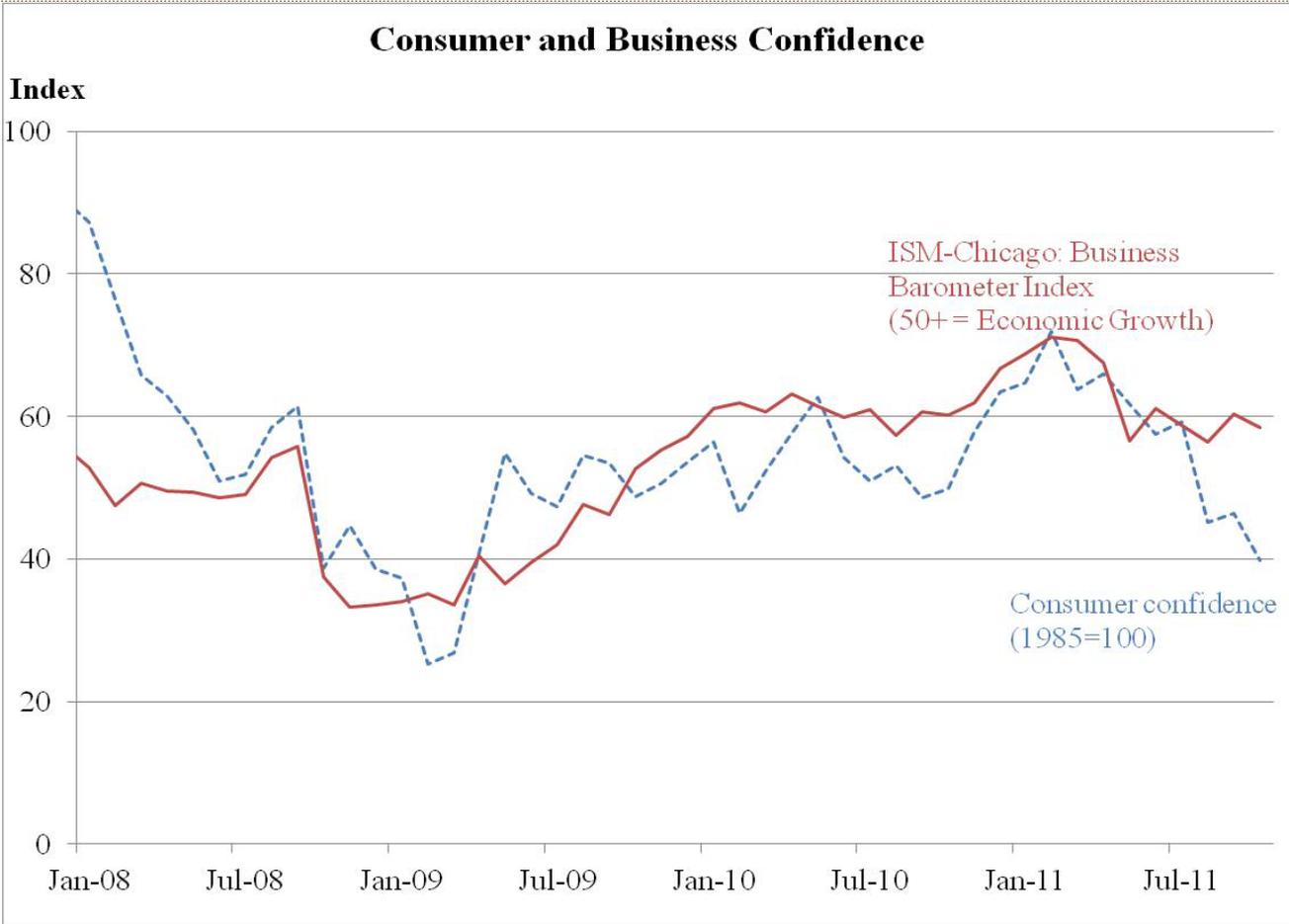
The recession scare



The recession scare



The recession scare



The effects of business and consumer confidence

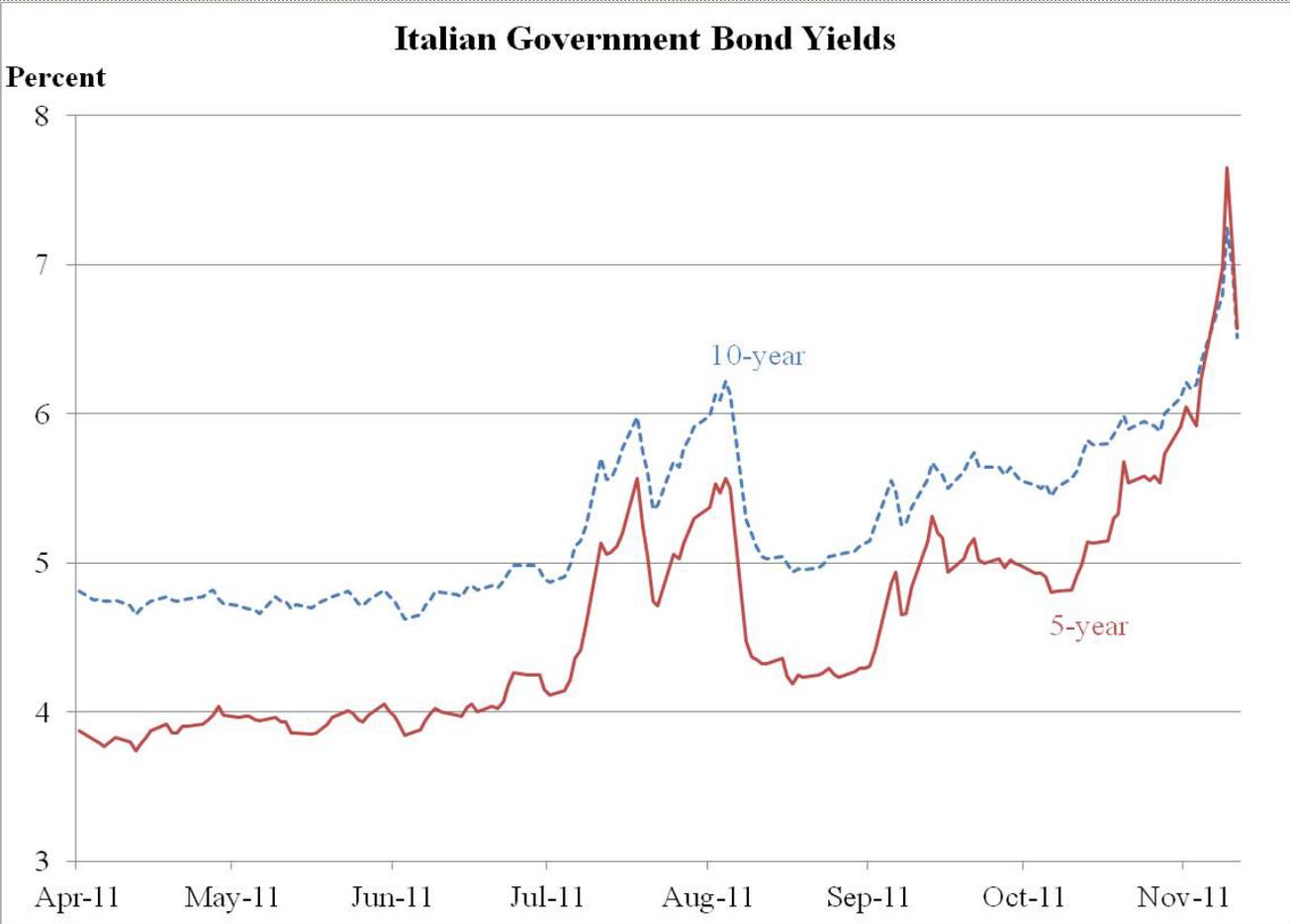
- Households are nervous due to the headlines from Europe, but in general Europe is viewed as too distant to force them to change behavior in a major way.
- Large businesses are also nervous about European headlines, but their growth strategies are in Asia, not in Europe, so they are not changing behavior either.
- So, despite drops in confidence, hard data on the U.S. economy continues to show moderate growth.

The European Situation

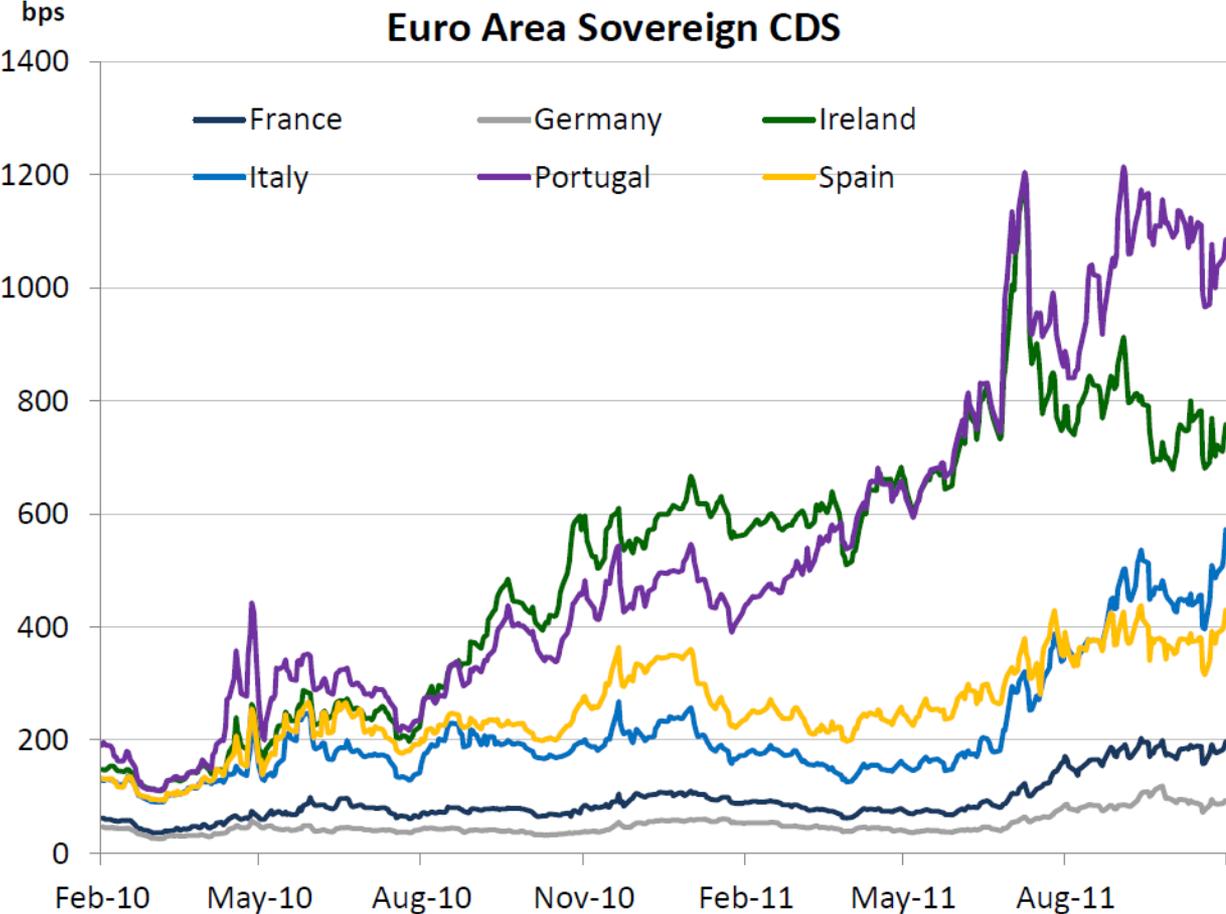
European politics

- Events in Europe pit a slow-moving political process against a fast-moving financial crisis.
- Results are unpredictable at this point, but European leaders tend to be very supportive of keeping the “European Project” of ever-greater European integration moving forward.
- The latest round of agreement includes better capital levels for European banks and an enhanced European Financial Stability Fund.

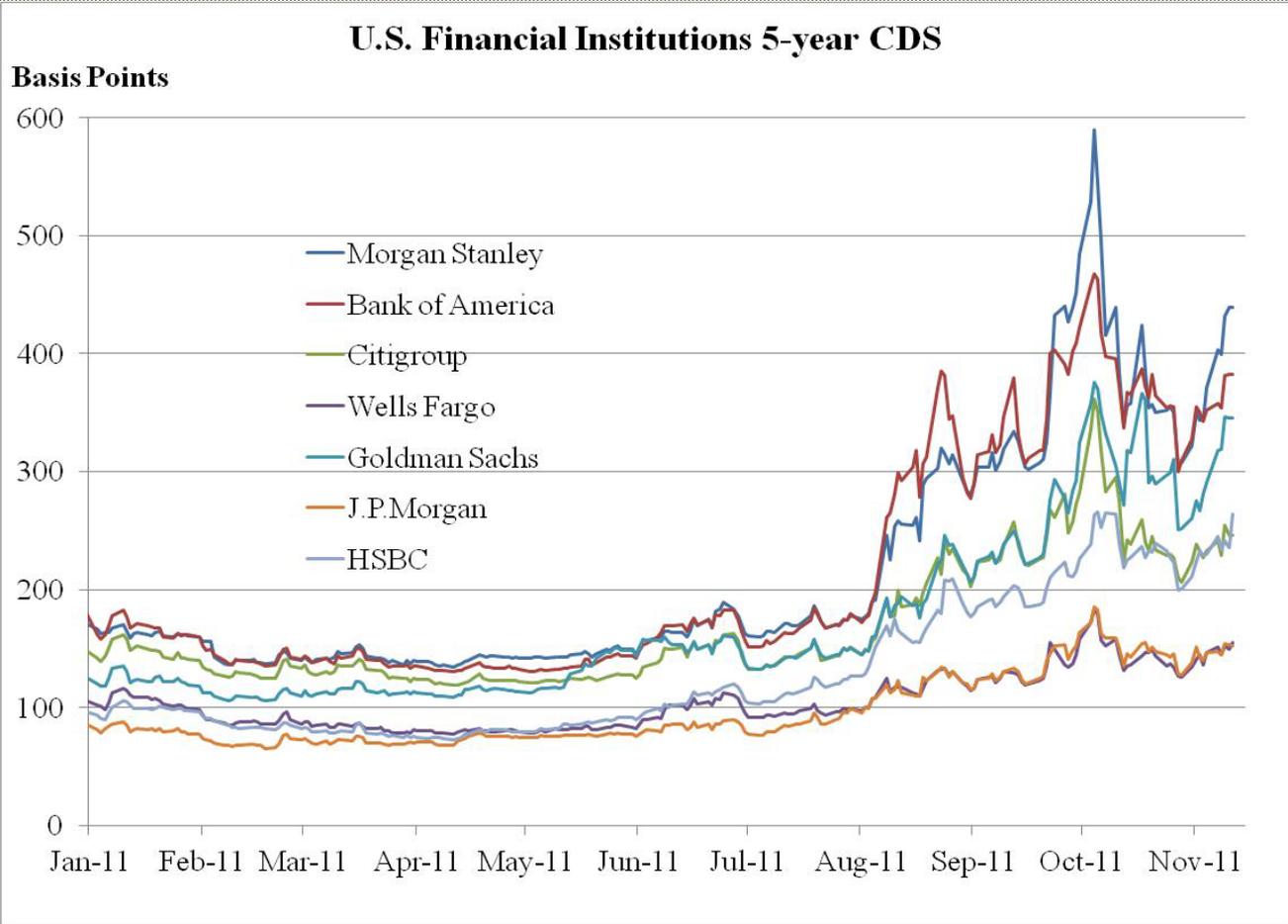
Europe



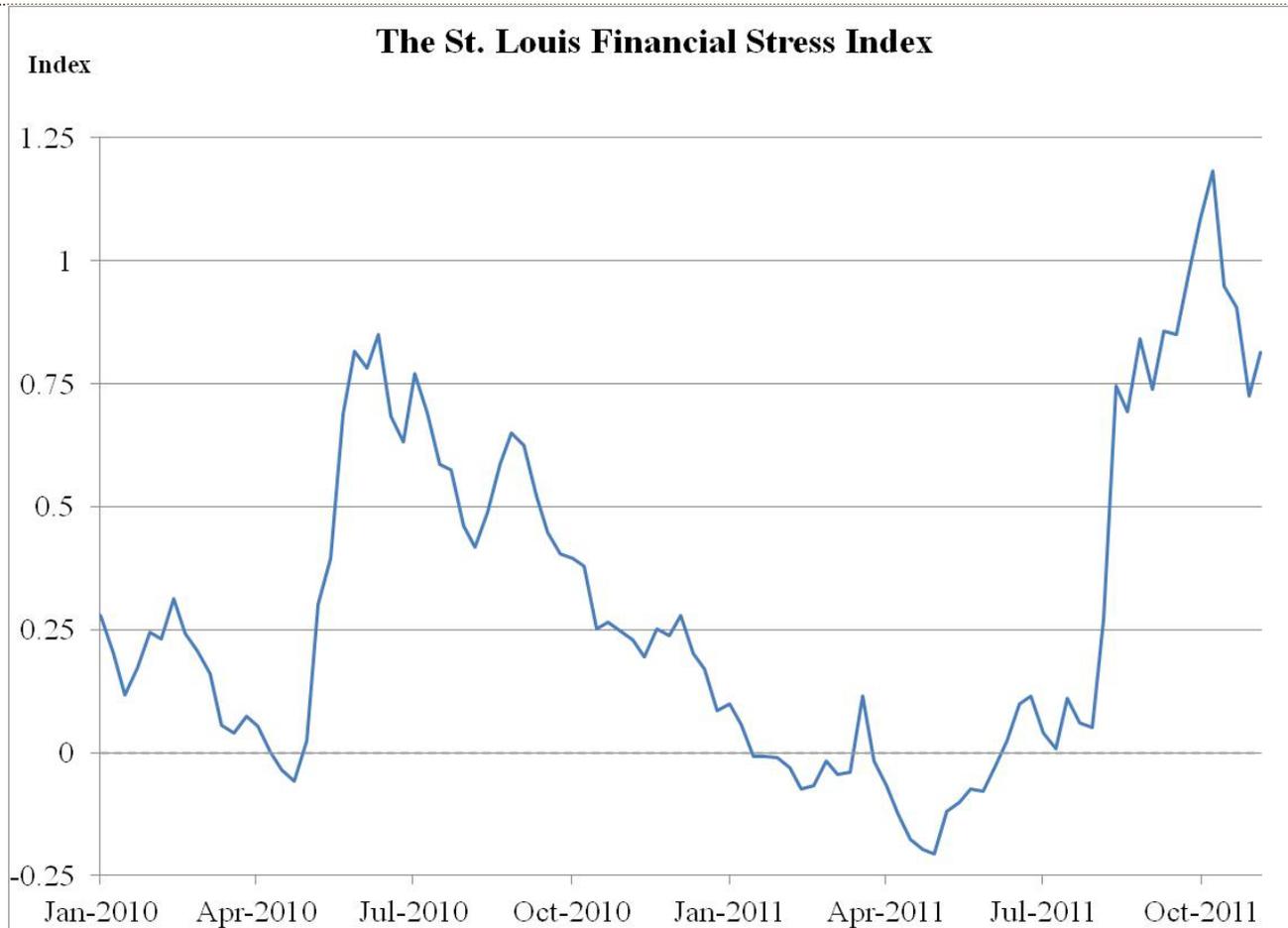
Europe



U.S. CDS for large financials



Financial stress



The Fed response

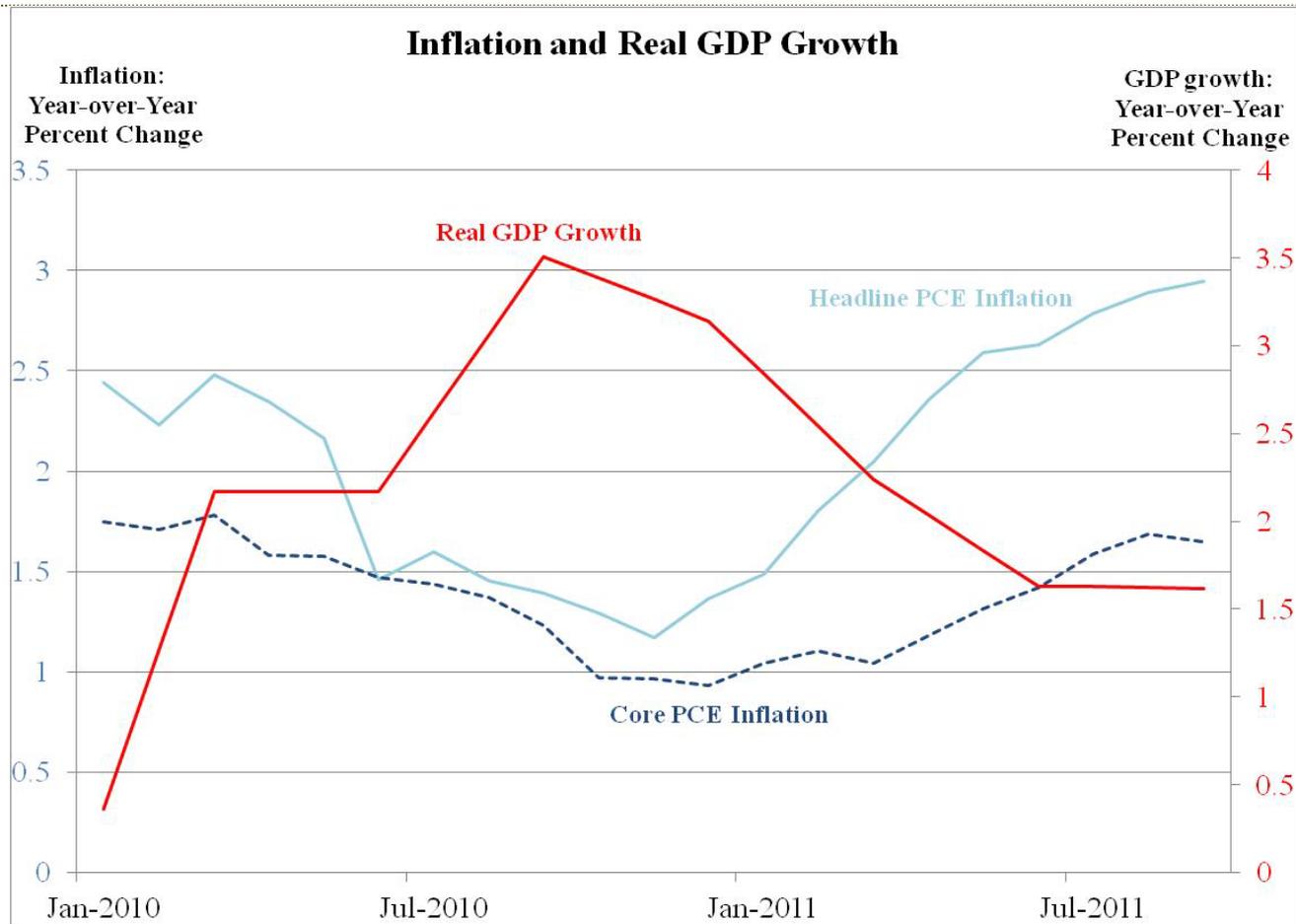
- If the situation worsens, the Fed can re-open some of the liquidity facilities that were used during 2008-2009.
 - These facilities were closed during the first quarter of 2010.

Recent Monetary Policy

A potent tool

- Outright asset purchases are a potent tool and must be employed carefully.
- 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 year, even though many measures of economic performance indicate that the economy was relatively weak.
- With the policy rate at zero, this means real short-term rates have declined.
 - For a review of the evidence on QE2, see my discussion “The Effectiveness of QE2.”*

Inflation turns around



Rules versus discretion

- A meeting-by-meeting balance sheet policy constitutes a rules-based approach because the Committee would make adjustments in response to economic events, just as in the interest rate targeting world.
- In contrast, the policy approach of the last several years, with announcements of large dollar amounts, fixed end dates, and rapidly changing tactics, seems fairly discretionary.

Alternative Approaches

An alternative approach: the communications tool

- An alternative would be for the Committee to 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.
- This is the so-called communications tool.
- The communications tool works inside models but has some important caveats for actual policy application.

The communications tool: credibility problems

- One is that it is not clear how credible actual announcements can be.
- If the economy is actually performing quite 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 “fall flat.”

Alternative frameworks?

- Some literature suggests that price-level targeting would provide better outcomes than inflation targeting.
- An older idea is for the Fed to target the level of nominal income.
- Chairman Bernanke stated that the Committee would stick with its flexible inflation targeting framework.

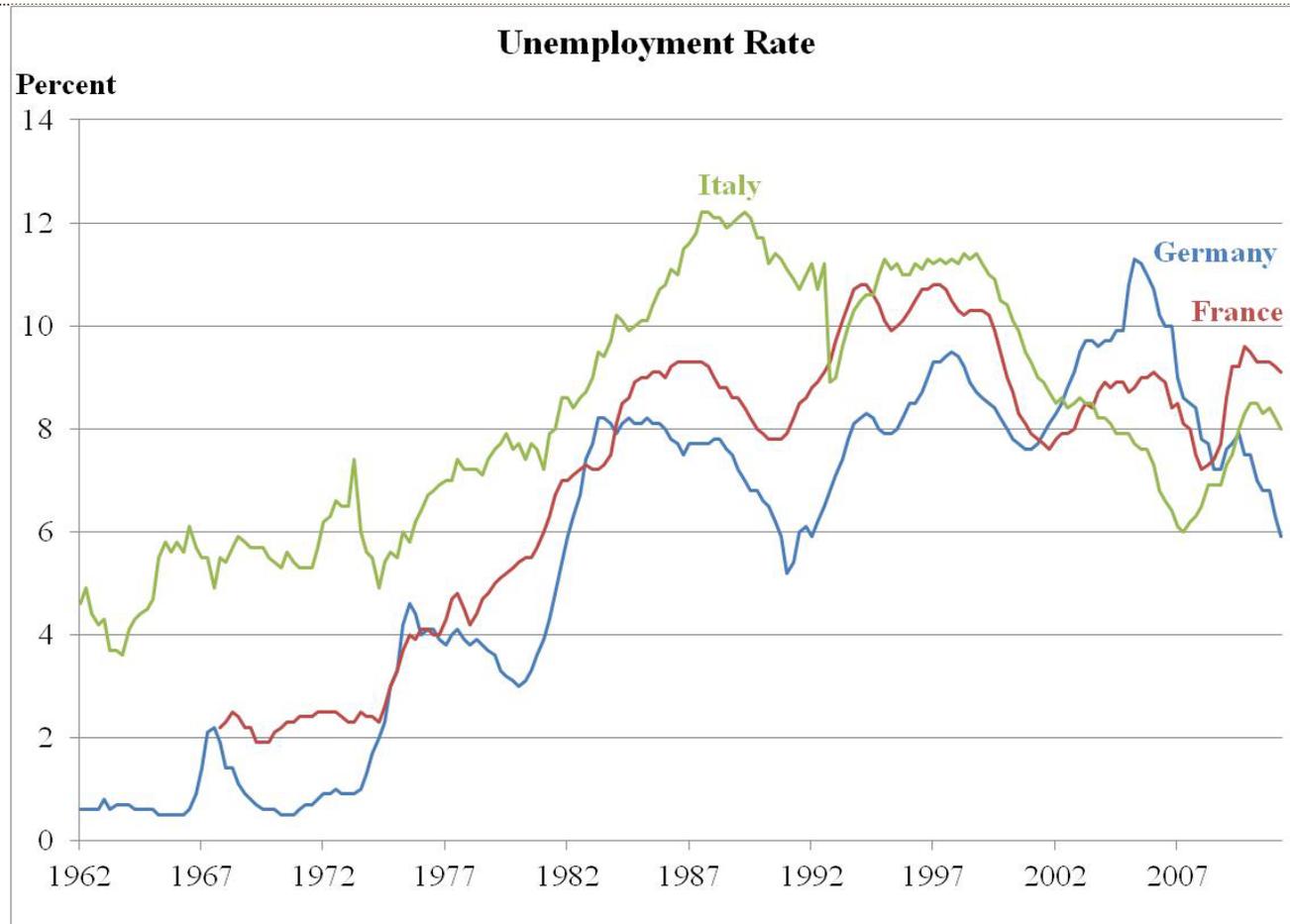
The communications tool: ties to actual outcomes?

- 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 14m unemployed people, against 140m employed and 86m 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

The U.S. macroeconomic outlook

- The U.S. economy has avoided the “recession scare” of last August.
- The FOMC has warned about “substantial downside risks,” mostly emanating from Europe.
- Tying monetary policy directly to the level of unemployment is unwise.



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