The U.S. Economic Situation and Recent Monetary Policy Developments

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Any opinions expressed here are my own and do not necessarily reflect those of others on the Federal Open Market Committee.

This talk.

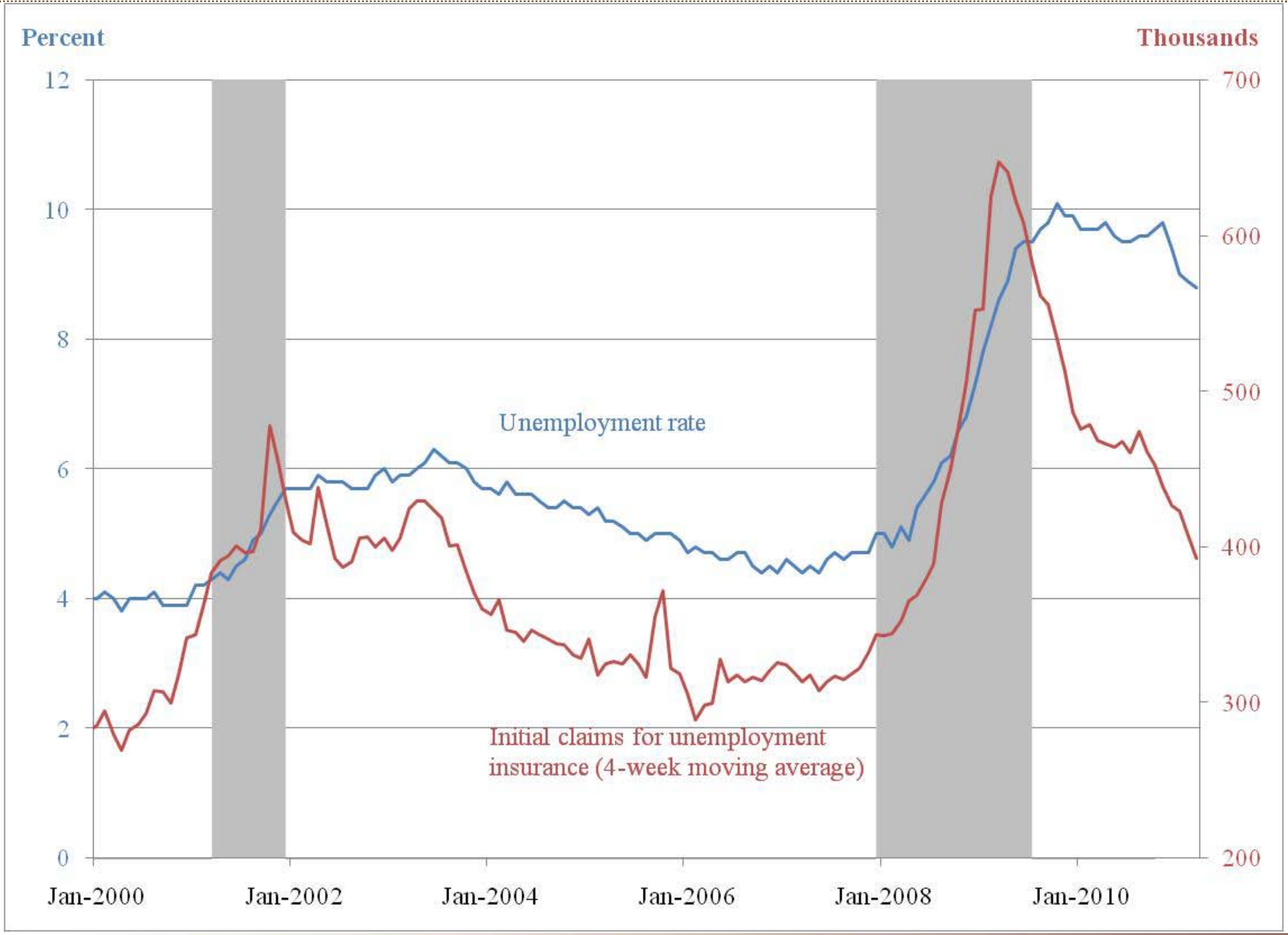
- The U.S. economic outlook.
  - Fundamentals remain reasonably strong for 2011.
  - Key global uncertainties are likely to dissipate.
- Monetary policy.
  - QE2 has been successful as classic policy easing.
  - Inflation and inflation expectations have recently moved higher.
  - Controlling headline inflation as the key policy goal.
- Inflation targeting = modern commodity standard.

The U.S. Economic Outlook

Fundamentals remain reasonably strong for 2011.

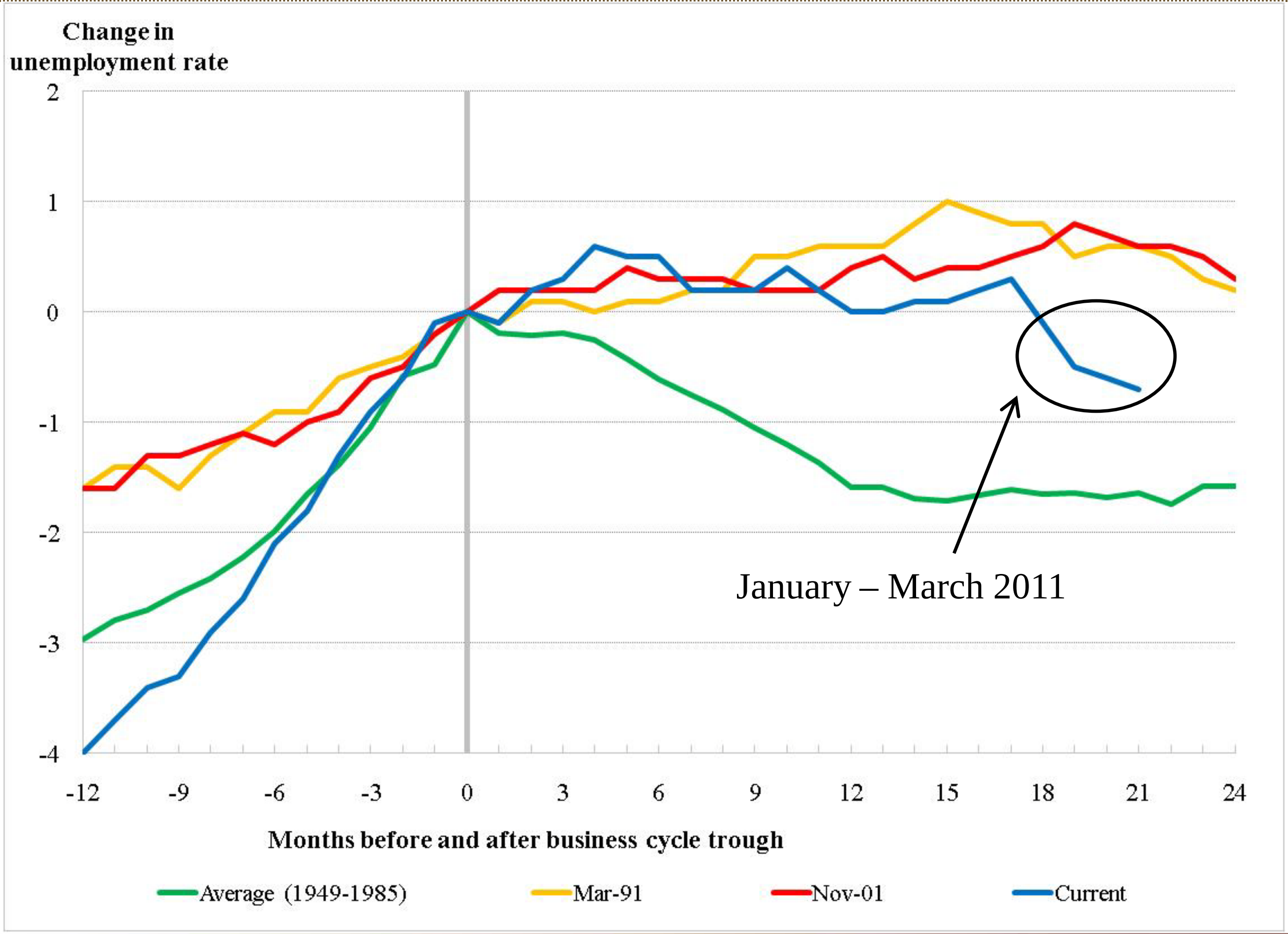
- Real GDP growth for the first quarter may be weaker than many expected a few months ago.
- However, the outlook for the remainder of 2011 remains reasonably strong.
- Labor market conditions have improved.
- Manufacturing activity remains robust.
- U.S. financial stress levels are near normal.
- A quartet of global uncertainties is likely to dissipate.

Unemployment and Initial Claims



Source: Bureau of Labor Statistics. Last observation: March 2011.

Unemployment: comparing recoveries



Source: BLS data and author's calculations. Last observation: March 2011.

Private sector job growth improving

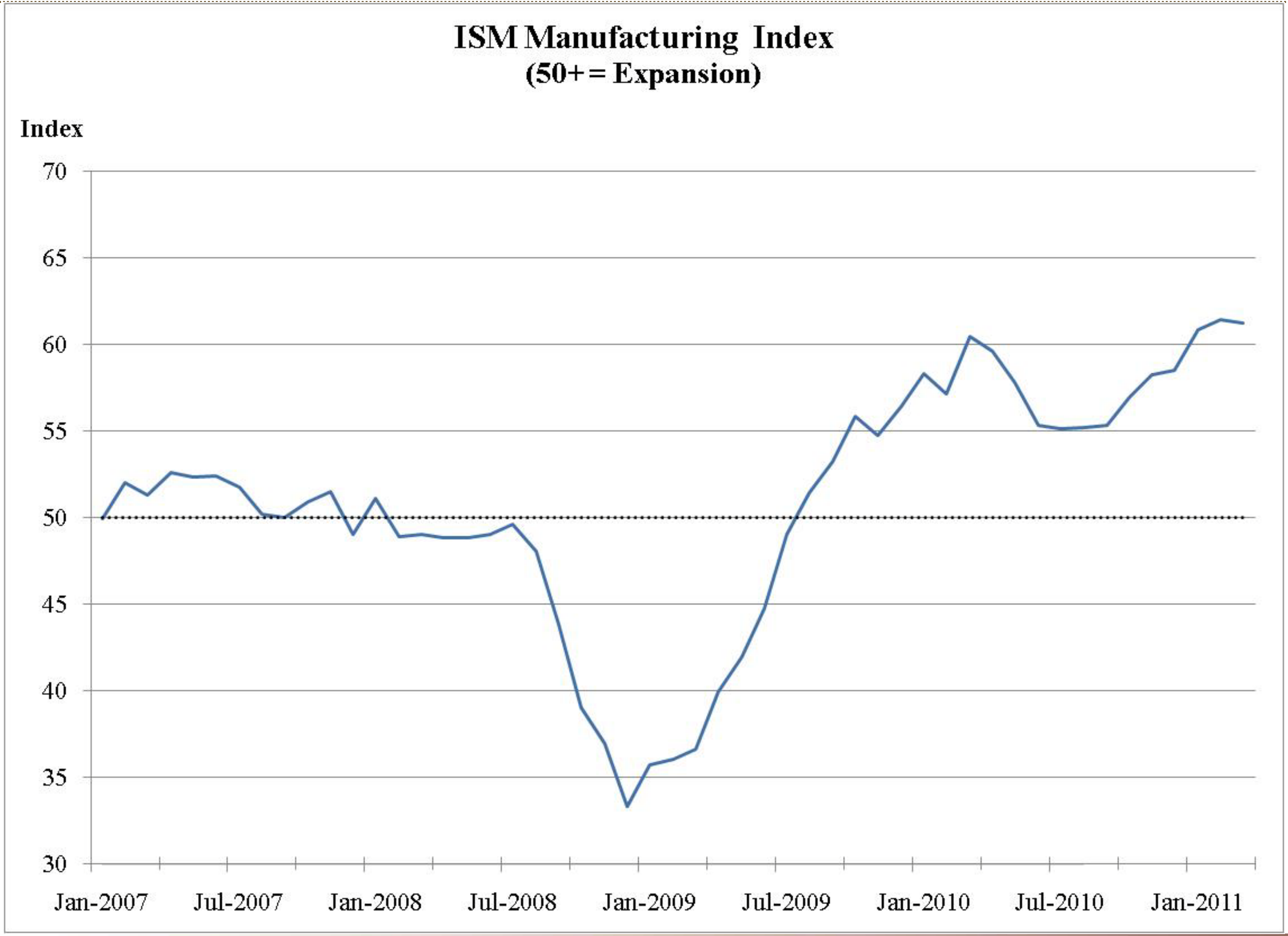
- About 1.6 million private sector jobs have been added to nonfarm payrolls over the last 12 months.

- That is about 138,000 per month.

- I expect this will accelerate during 2011.
  - U.S. firms have cash and are looking for opportunities to invest.

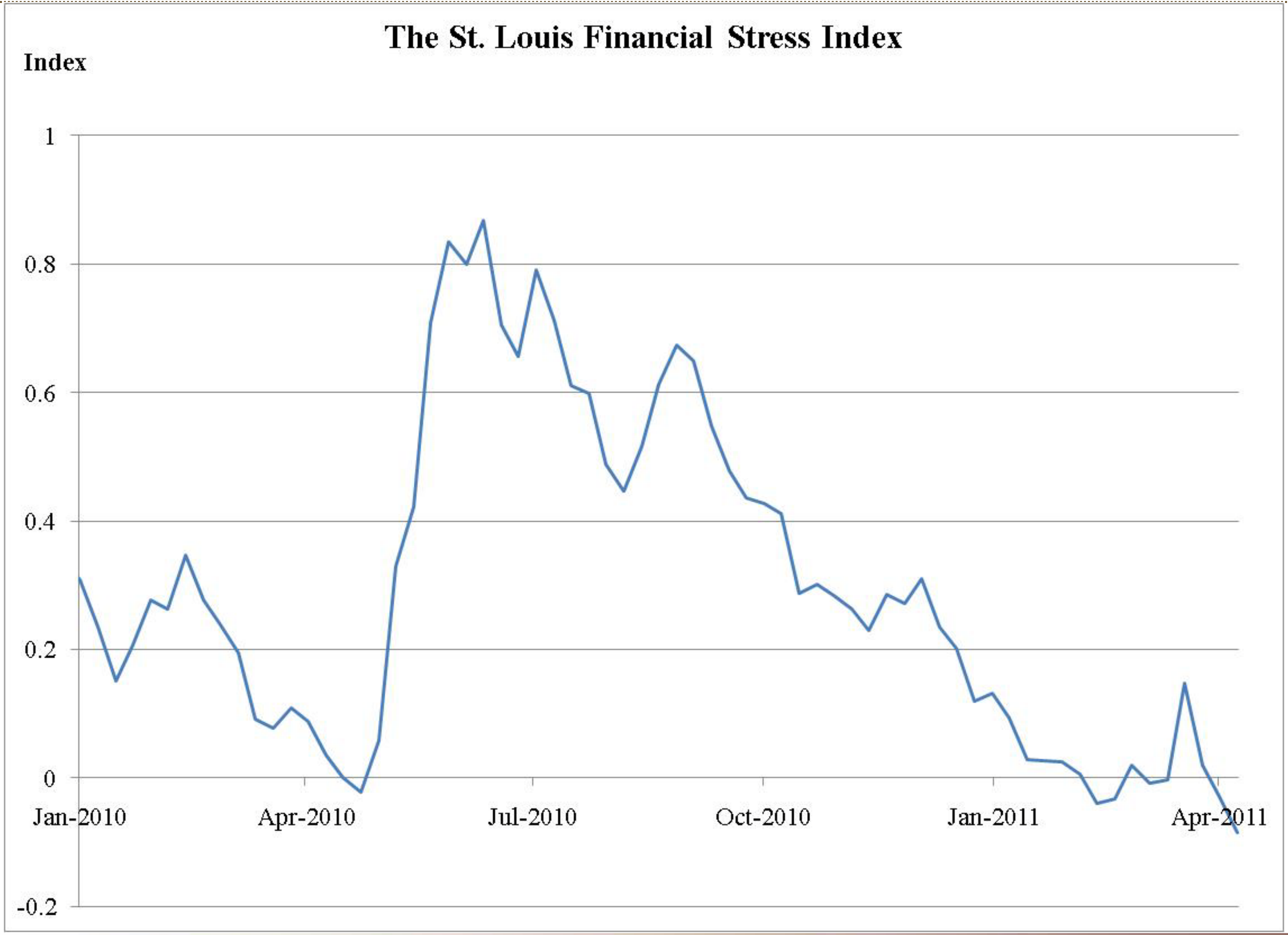
Source: BLS data and author's calculations. Last observation: March 2011.

Manufacturing is robust



Source: Institute for Supply Management. Last observation: March 2011.

U.S. financial stress is at normal levels



Source: Federal Reserve Bank of St. Louis. Last observation: April 8, 2011.

A quartet of uncertainties

- In recent weeks, macroeconomic uncertainty has been on the rise from four key sources.
- One has been turmoil in the Middle East and North Africa, and the associated uncertainty premium in oil prices.
- Another has been the natural disaster in Japan and the damaged nuclear reactors there.
- A third has been the U.S. fiscal situation and the possibility of a political stalemate.
- And finally, continued uncertainty regarding resolution of the European sovereign debt crisis.

Prospects are for each situation to be contained

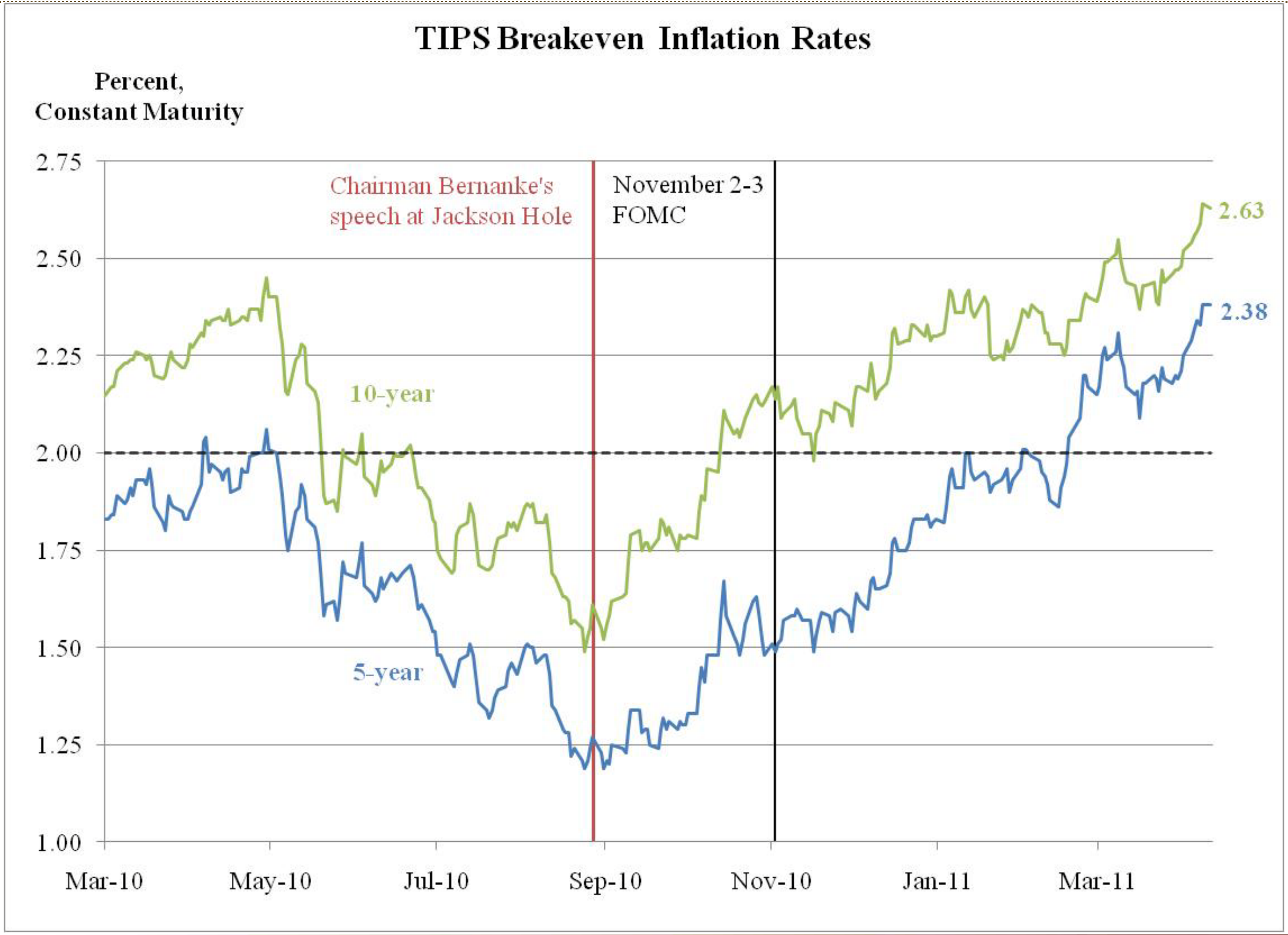
- All four situations contain potential for escalation.
- If escalation occurs, all bets are off.
- Still, the most likely prospect is that all four are resolved without becoming global macroeconomic shocks.

Monetary Policy Issues

The effects of asset purchases in financial markets

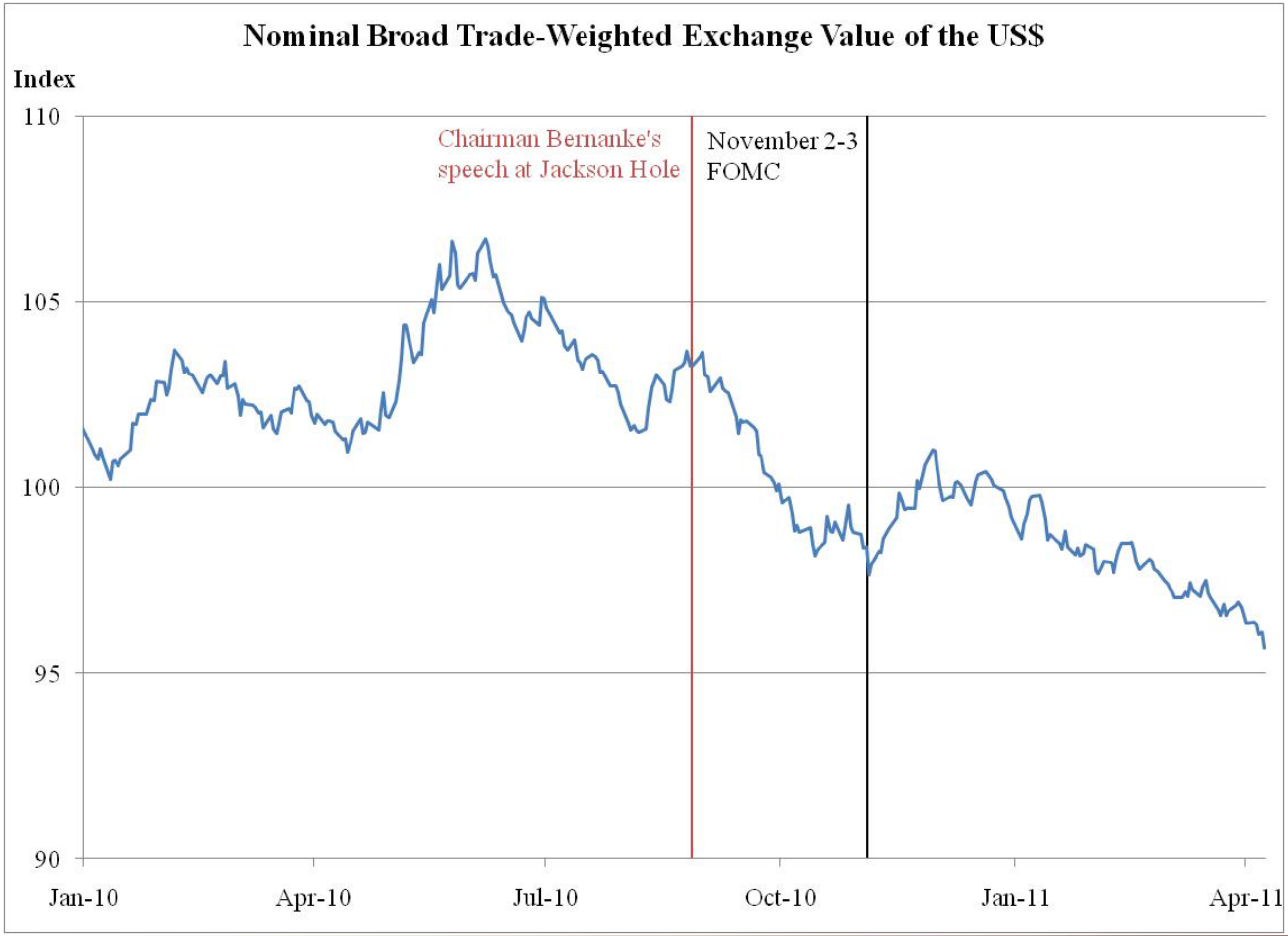
- The financial market effects of QE2 looked the same as if the FOMC had reduced the policy rate substantially.
- In particular, real interest rates declined, inflation expectations rose, the dollar depreciated, and equity prices rose.
- These are the "classic" financial market effects one might observe when the Fed eases monetary policy in ordinary times (that is, in an interest rate targeting environment).

Expected inflation increased



Source: Federal Reserve Board. Last observation: April 11, 2011.

The dollar depreciated



Source: Federal Reserve Board. Last observation: April 8, 2011.

Real interest rates declined

Source: Federal Reserve Board. Last observation: April 8, 2011.

Equity prices increased

Source: Wall Street Journal. Last observation: April 11, 2011.

Classic monetary policy easing

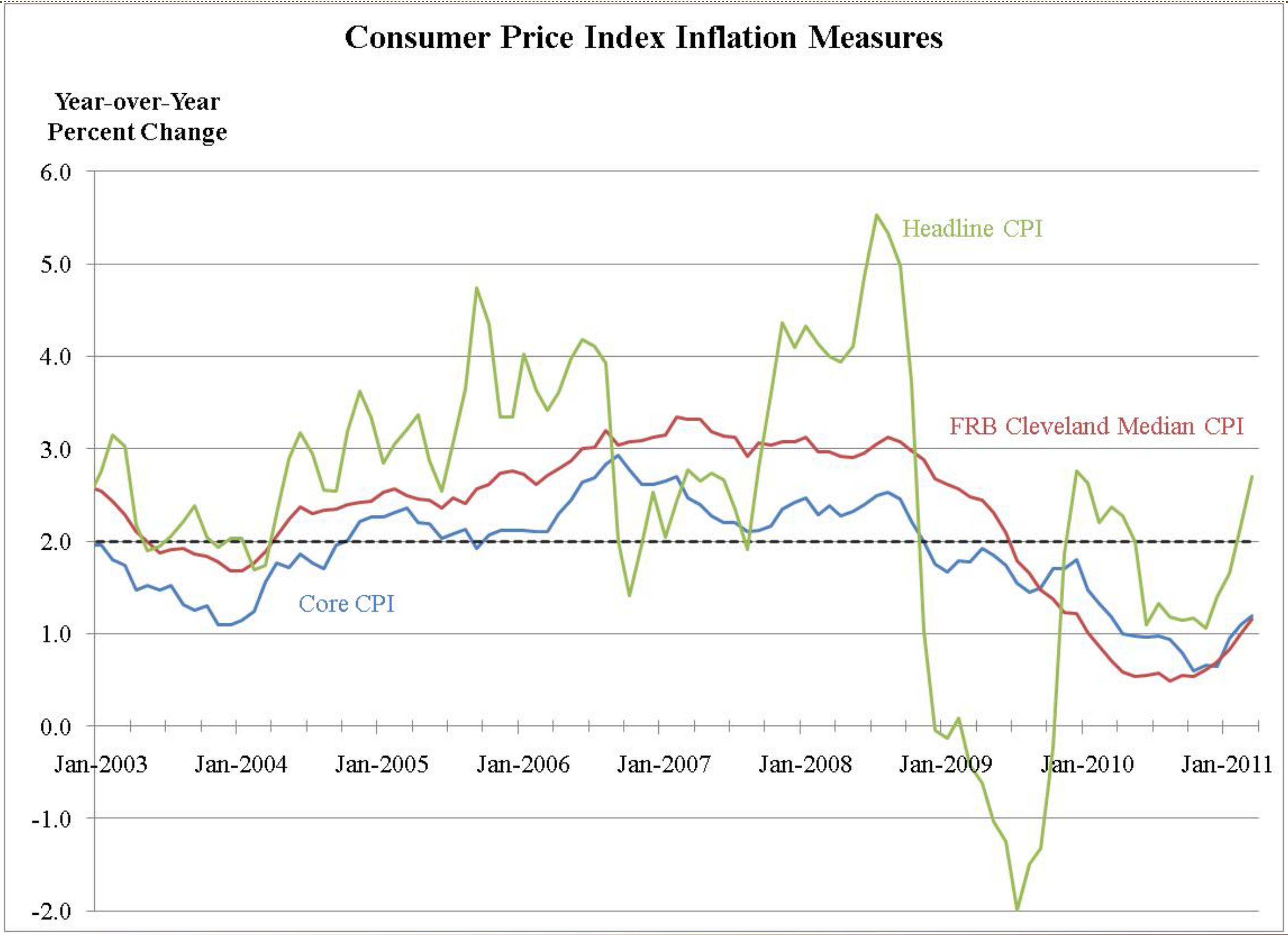
- This experience shows that monetary policy can be eased aggressively even when the policy rate is near zero.

Core Versus Headline Inflation

Core versus headline inflation

- Headline inflation refers to overall price indexes.
- Core inflation refers to the same indexes, but without the food and energy components.
- Core inflation is often smoother than headline inflation.
  - Core eliminates 20% or so of the prices in the index.
- The "core" concept has little theoretical backing. It is very arbitrary.

CPI Inflation: Headline versus Core



Source: Bureau of Economic Analysis. Last observation: March 2011.

Headline inflation is the ultimate objective

- Headline inflation is the ultimate objective of monetary policy with respect to prices.
- These are the prices households actually pay.
- The only reason to look at core is as an indicator for headline.
- Core inflation is not an objective in itself.

Too much attention to core can mislead

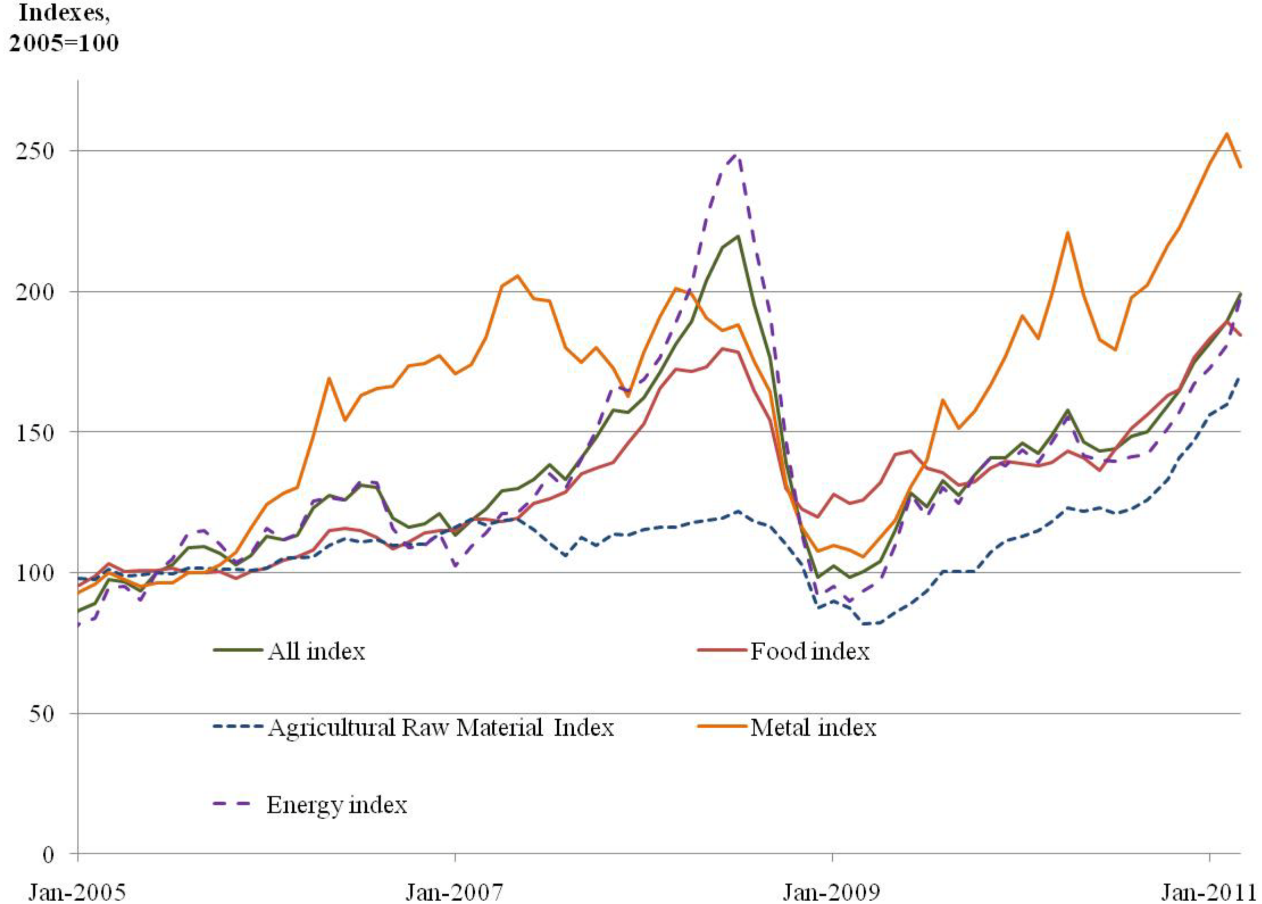
- From 2003-2006, core inflation was consistently below headline inflation.
- Core inflation averaged about 2.0 percent during this period.
- But headline inflation averaged about 2.9 percent for the CPI, and about 2.6 percent for the PCE.
  - That is substantial over a period of four years.
  - Core was not a good indicator of headline during this period.
  - Energy prices were rising and the economy was expanding.

Commodity standards

Commodity standards

- Commodity standards were last discussed in the 1970s, when U.S. inflation was high and variable.
- Ironically inflation is quite low today.
- Tying the currency to commodities when commodity prices are highly variable is questionable.

Indexes of commodity prices



Source: International Monetary Fund. Last observation: March, 2011.

Inflation targeting substitutes for a commodity standard

- A commodity standard forces accountability on the central bank.
  - It did not always work, because governments sometimes changed the rate between the commodity and the currency.
- Inflation targeting is another way to force more accountability to the central bank and anchor longer-term expectations.
  - Make the central bank say what it intends to do, and hold the central bank accountable for achieving the goal.
- In this sense, inflation targeting is the modern successor to a commodity standard.
- Inflation targeting is a better choice in the current environment.

Conclusions

Conclusion

- U.S. growth prospects remain reasonably good for 2011.
- QE2 has shown that the Fed can conduct an effective monetary policy even when policy rates are near zero.
- Headline inflation, not core, is the key policy goal with respect to prices.
- Inflation targeting = modern commodity standard.

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