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
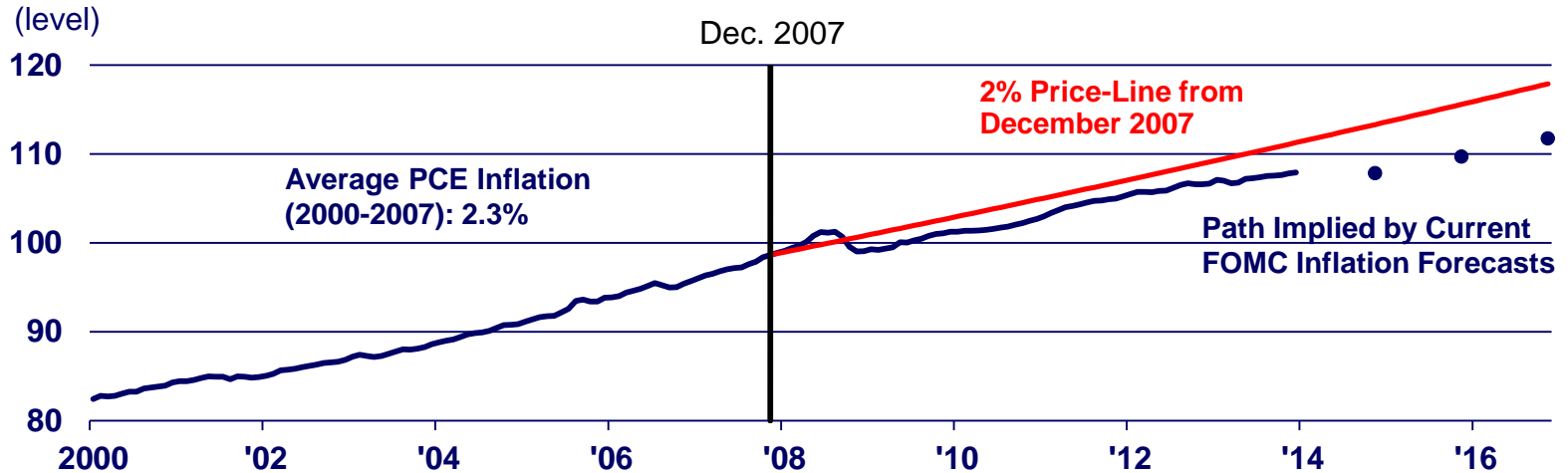
Long-Run Strategy for Monetary Policy
(January 2012, reaffirmed thereafter every January)
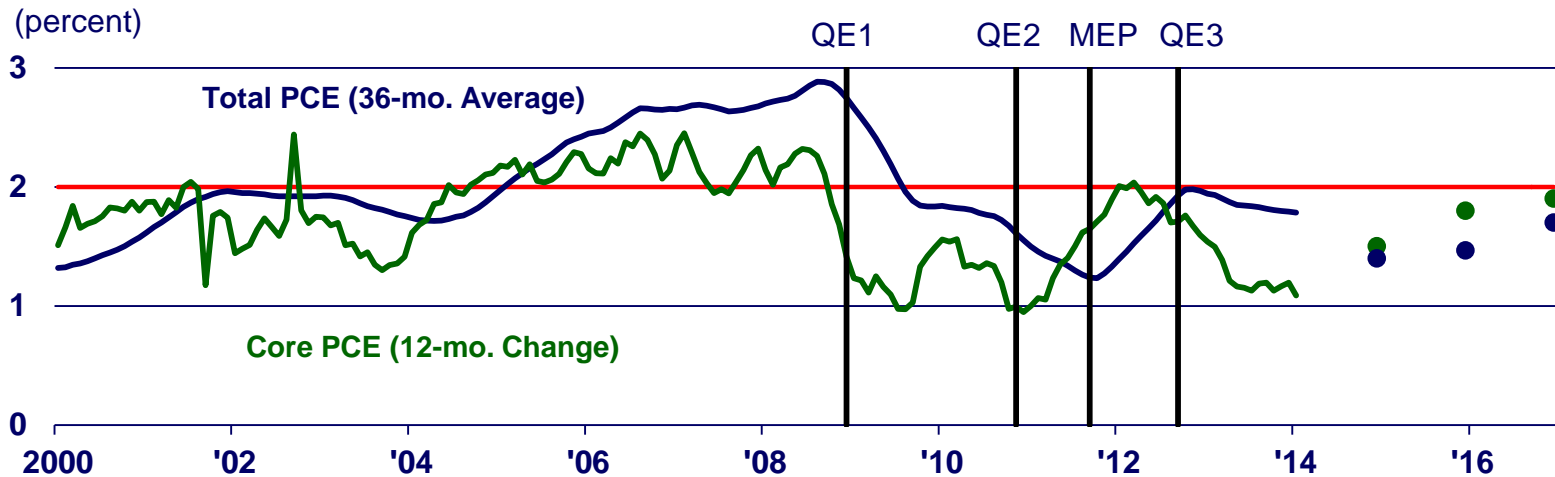
- $\pi^* = 2\%$ PCE inflation

- $U_t^* \sim 5.2\% - 5.8\%$ 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?

Total PCE Price Index

(level)

Dec. 2007

2% Price-Line from December 2007

Average PCE Inflation (2000-2007): 2.3%

Path Implied by Current FOMC Inflation Forecasts

120
110
100
90
80

2000   '02   '04   '06   '08   '10   '12   '14   '16

Inflation

(percent)

QE1   QE2   MEP   QE3

Total PCE (36-mo. Average)

Core PCE (12-mo. Change)

3
2
1
0

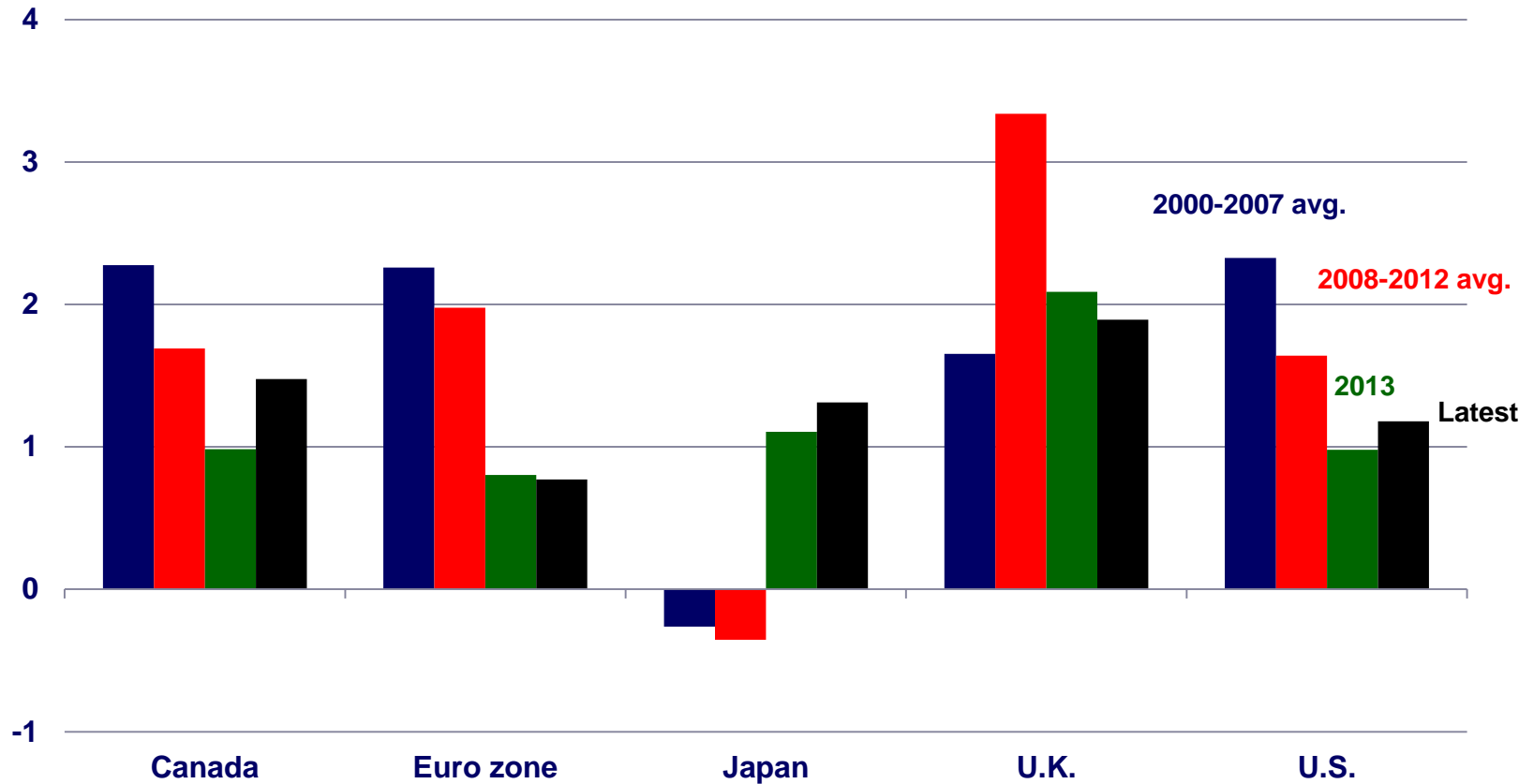2000   '02   '04   '06   '08   '10   '12   '14   '16

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

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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.

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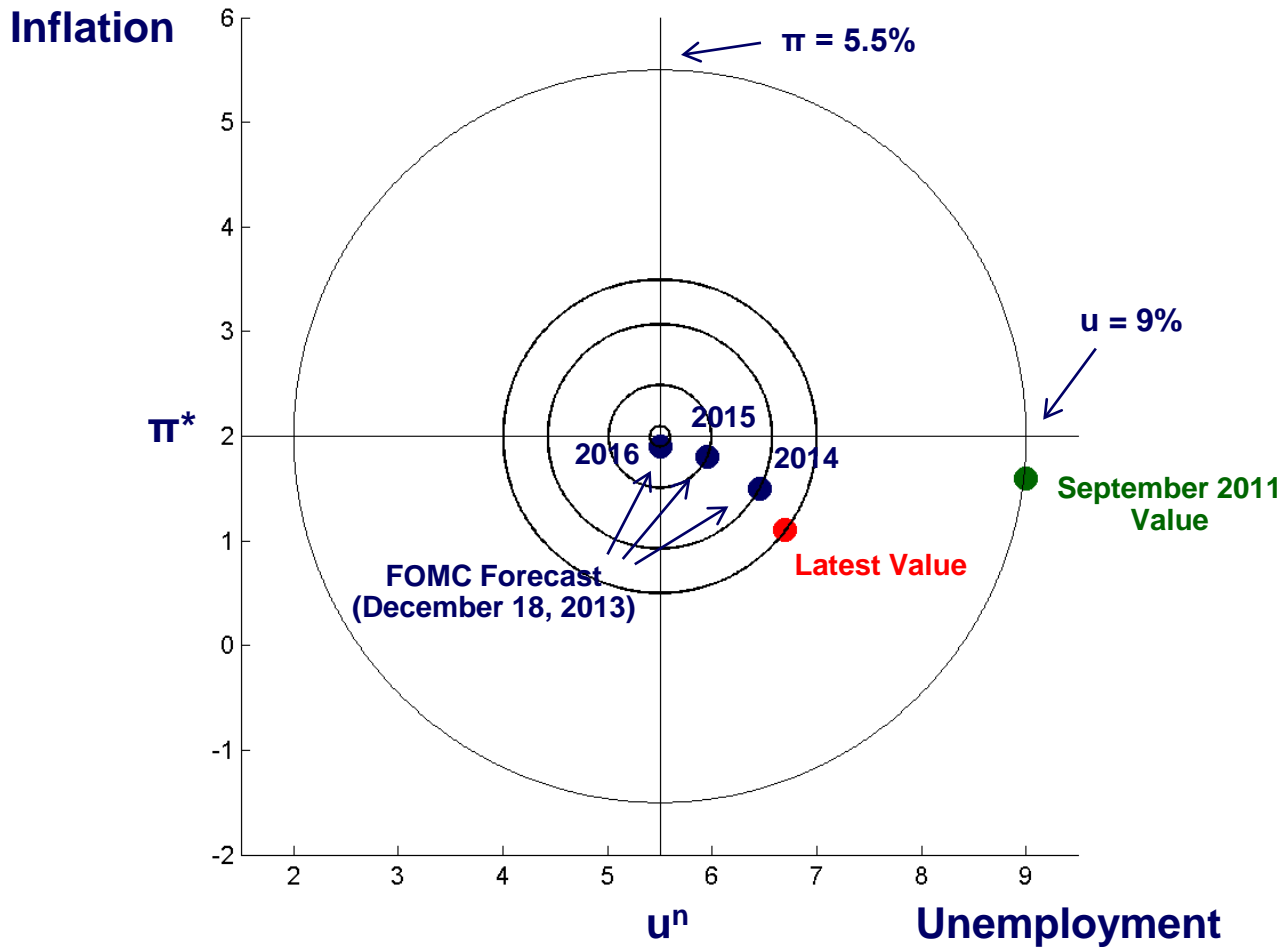## (January 2012, reaffirmed thereafter every January)

- $\pi^* = 2\%$ PCE inflation

- $U_t^* \sim 5.2\% - 5.8\%$ 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**

Balanced Approach to the Dual Mandate Is Consistent with Mainstream Macroeconomics

Loss Function
(percent)

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

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

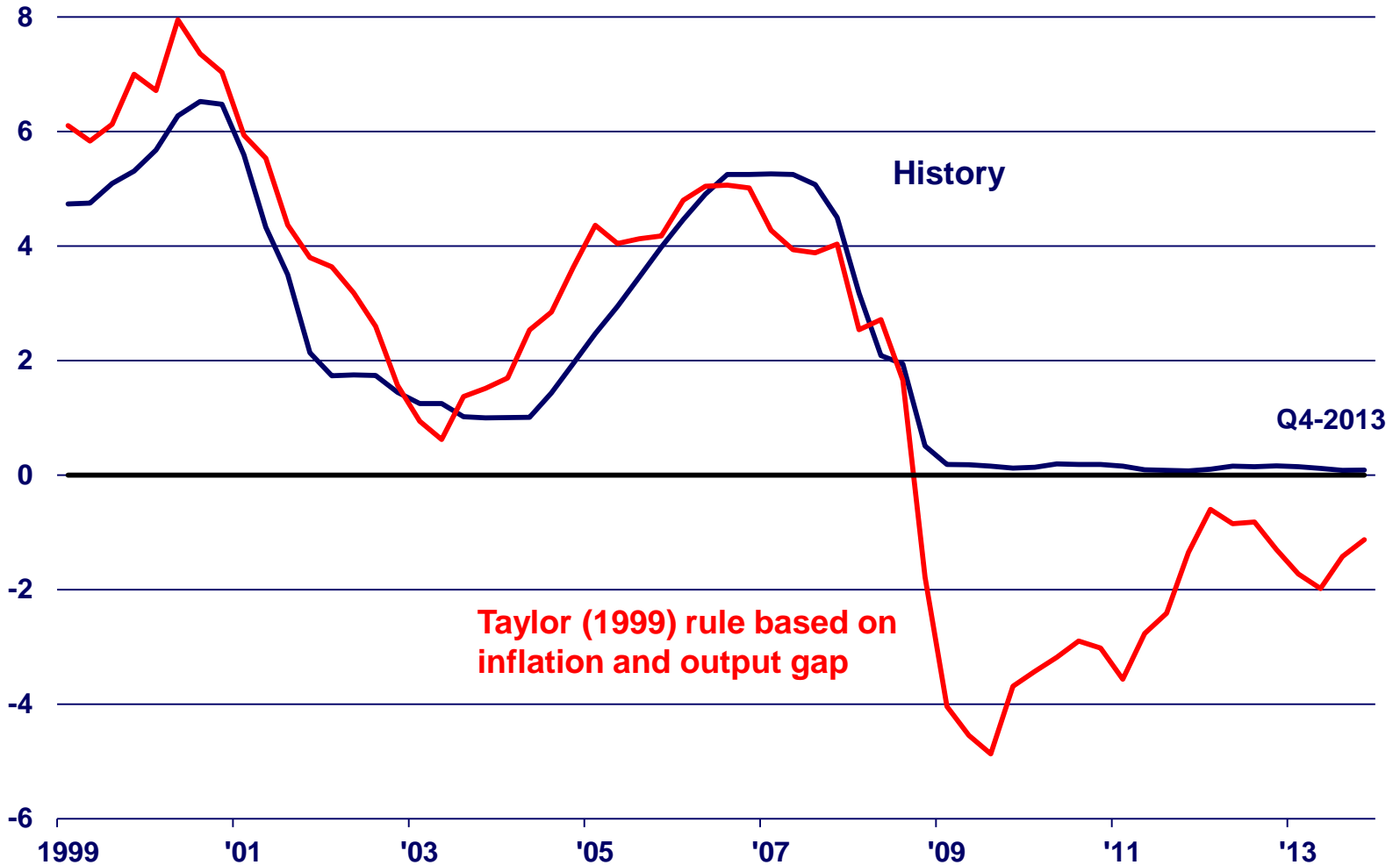# Why Has Achieving Dual Mandate Been So Hard?

- **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

Fed Funds Rate
(percent)

History

Q4-2013

Taylor (1999) rule based on inflation and output gap
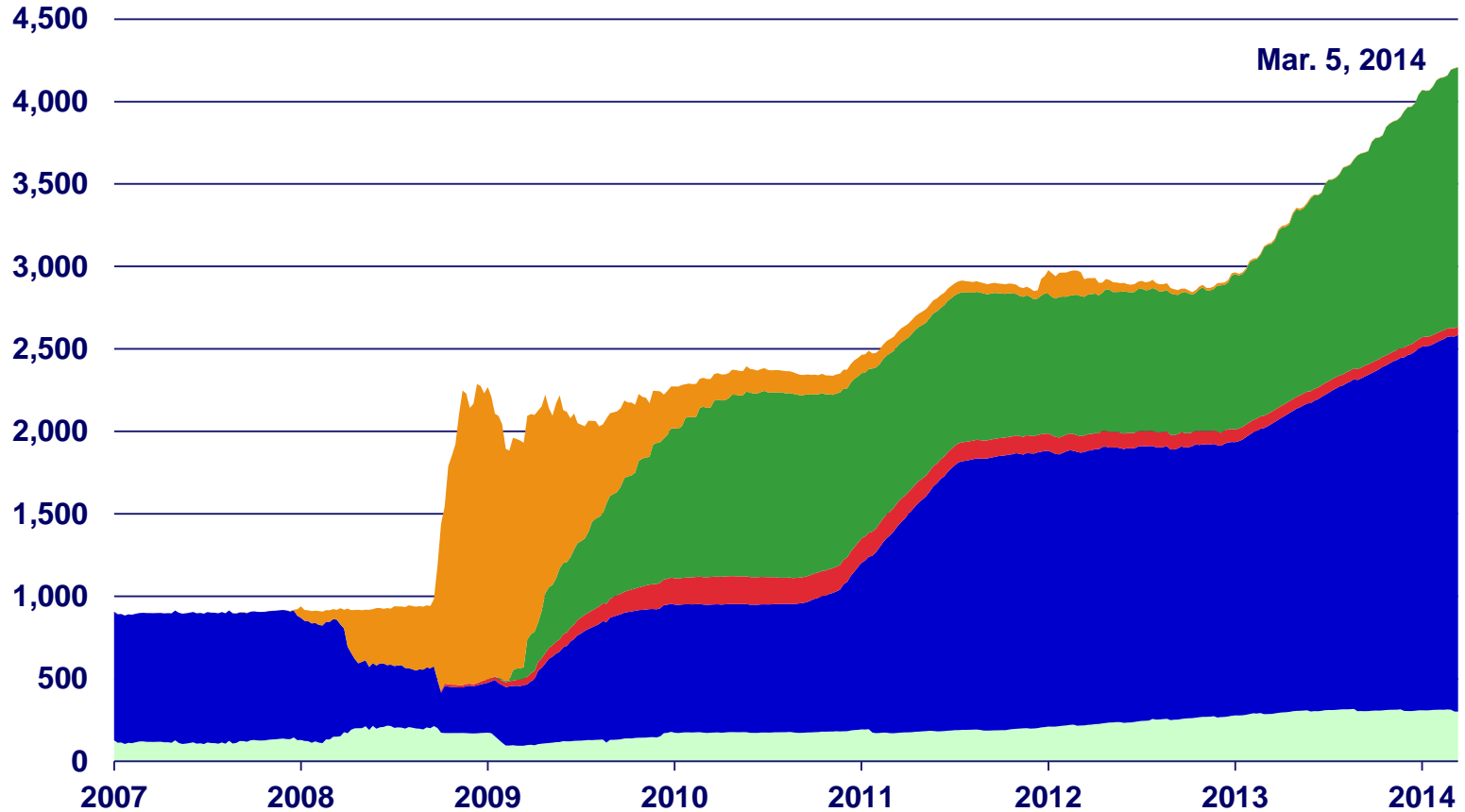
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Policy Tools at the Zero Lower Bound

- **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

Federal Reserve Assets
(Bil. $)

Mar. 5, 2014

Legend:
- All Other Assets ($301.5 bil.)
- Agency Debt ($51.4 bil.)
- Lending and Liquidity Facilities ($2.2 bil.)
- Treas. Sec ($2,284.2 bil.)
- Agency MBS ($1,570.1 bil.)

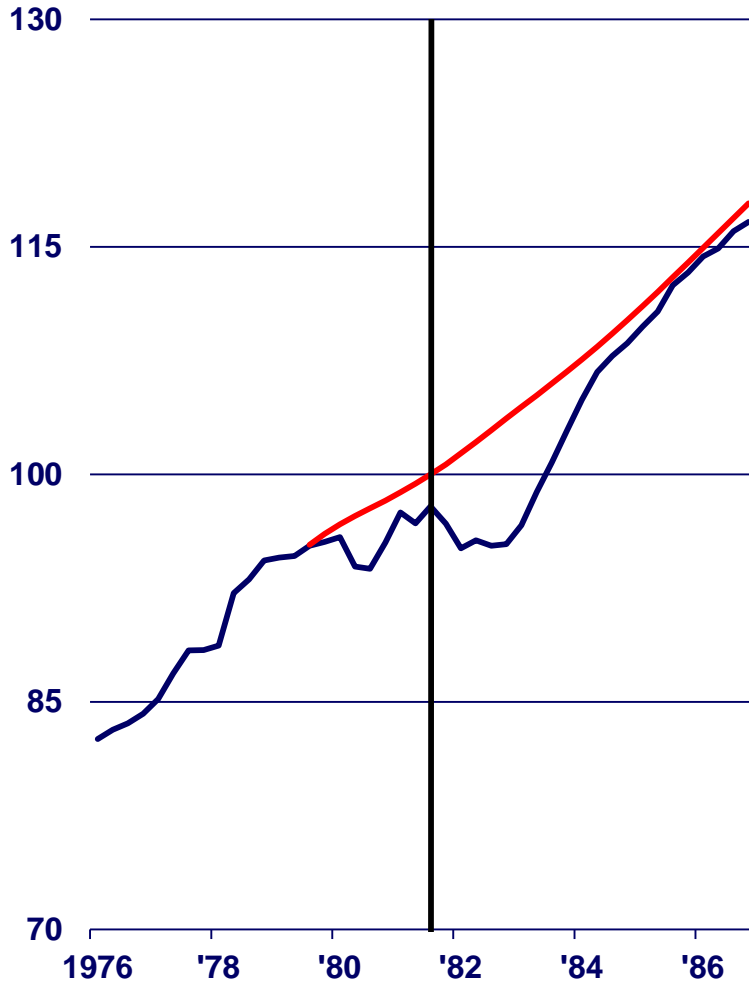# Forward Guidance on the Federal Funds Rate

- **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.**
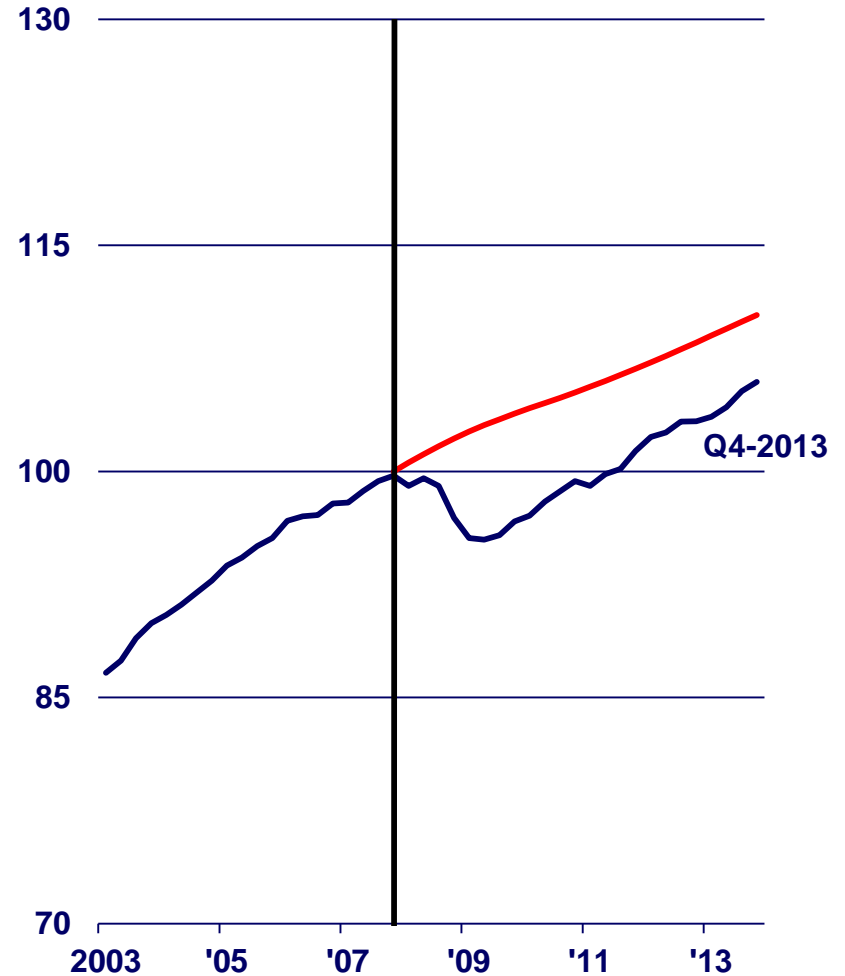
Output Gap: 1982 Recovery vs. Today

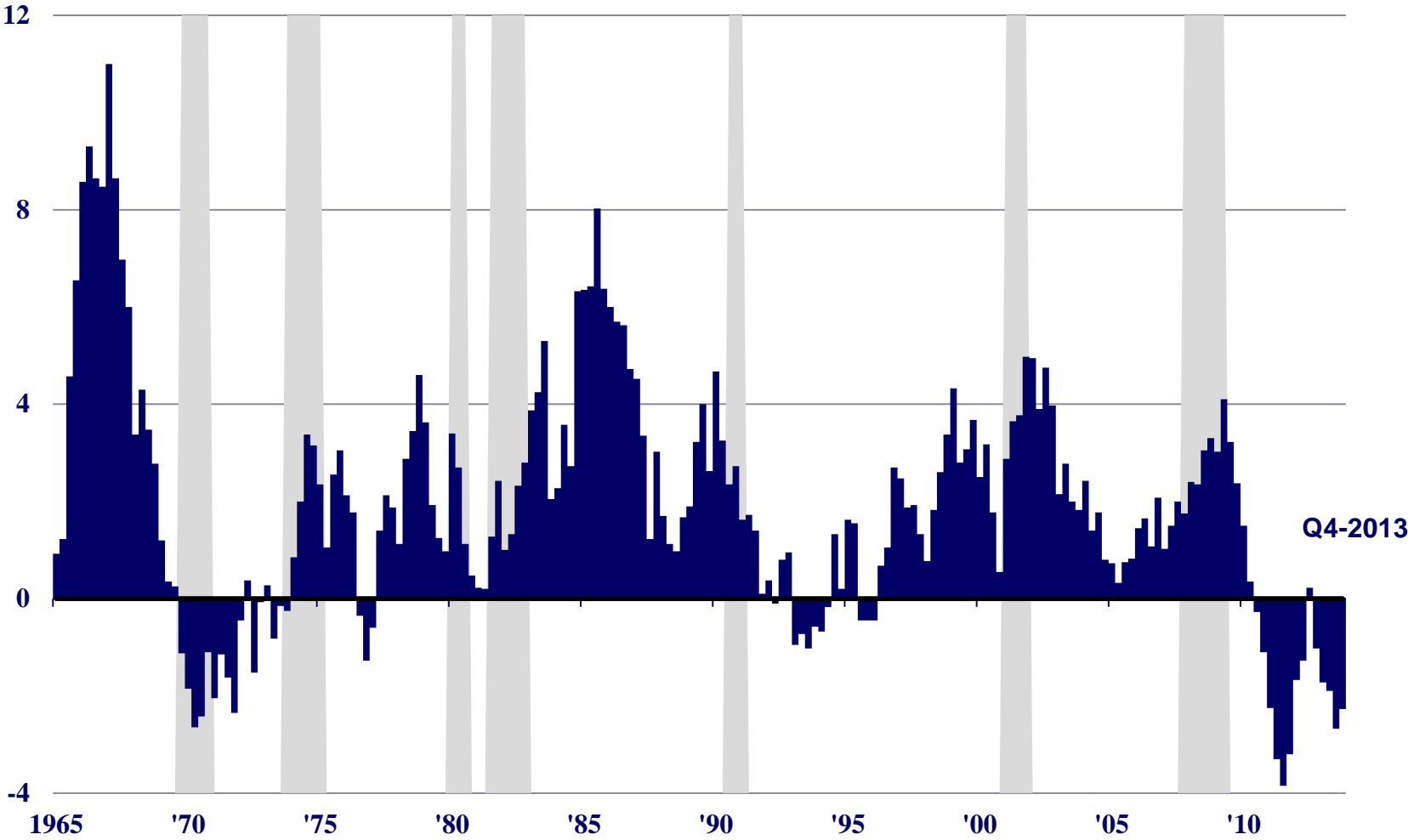**Actual and Potential GDP: 1982**
(1981 Q3 = 100)

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

Q4-2013

Fiscal Policy: Historically Unusual

Contributions of Government Purchases to Real GDP Growth
(percent)

Q4-2013

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**