The Economic Outlook and Unconventional Monetary Policy

Eric S. Rosengren
President & CEO
Federal Reserve Bank of Boston

Babson College
Wellesley, Massachusetts

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Overview

- Open-ended purchase of MBS worked as expected
  - Financial reaction more than some expected
  - Improvements in interest-sensitive sectors
- Inflation close to target since 2000 and below target currently

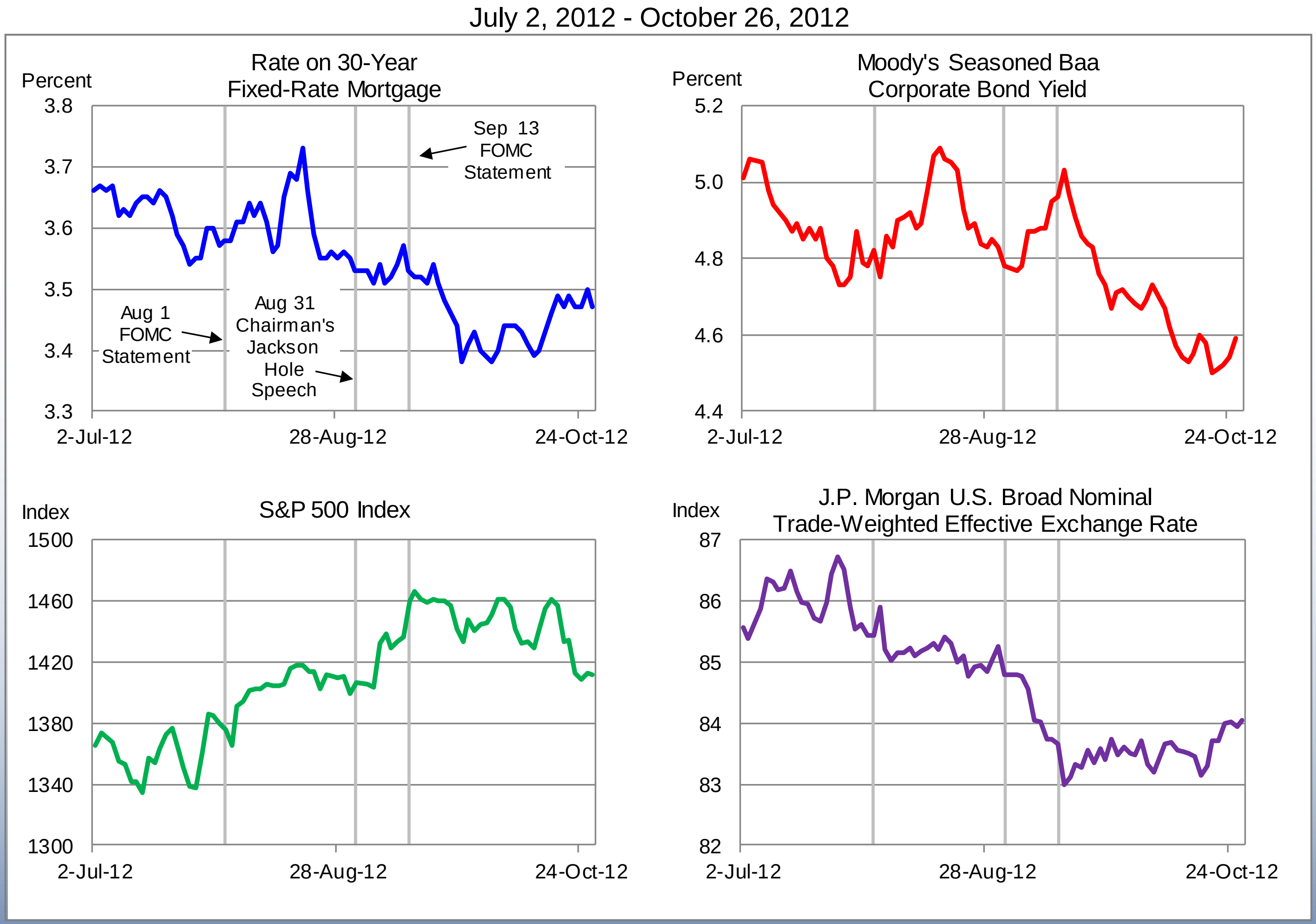
Overview Continued…

- When to stop asset purchases is complicated
  - Begin discussion when unemployment has fallen **at least** ½ percent – 7.25 percent
  - I see it as a threshold that starts the discussion – not a trigger that initiates action
- My view: More like 6.5 percent unemployment to warrant the federal funds rate being lifted off the zero bound

Outlook

- Recovery has averaged roughly 2 percent growth – faster than many developed countries but too slow to quickly improve labor markets
- Action to stimulate more growth
  - Purchase $40 billion in MBS until significant improvement in labor markets
  - Continue maturity extension program
  - Indicate that short-term rates are expected to remain exceptionally low through mid-2015

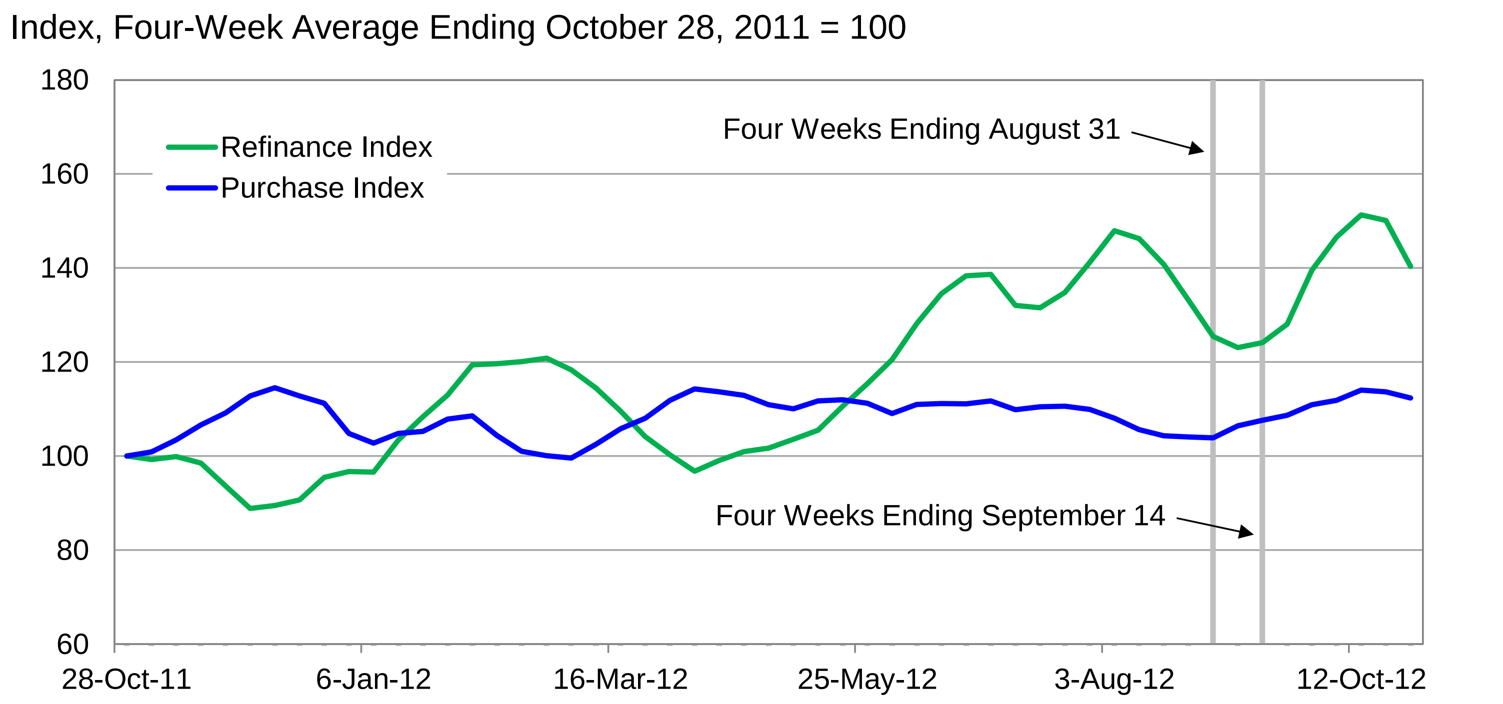
Figure 1
Financial Market Response to FOMC Announcement



Source: Federal Reserve Board, J.P. Morgan, NYT, WSJ / Haver Analytics

Figure 2
Mortgage Loan Applications

Four-Week Moving Average, October 28, 2011 - October 26, 2012

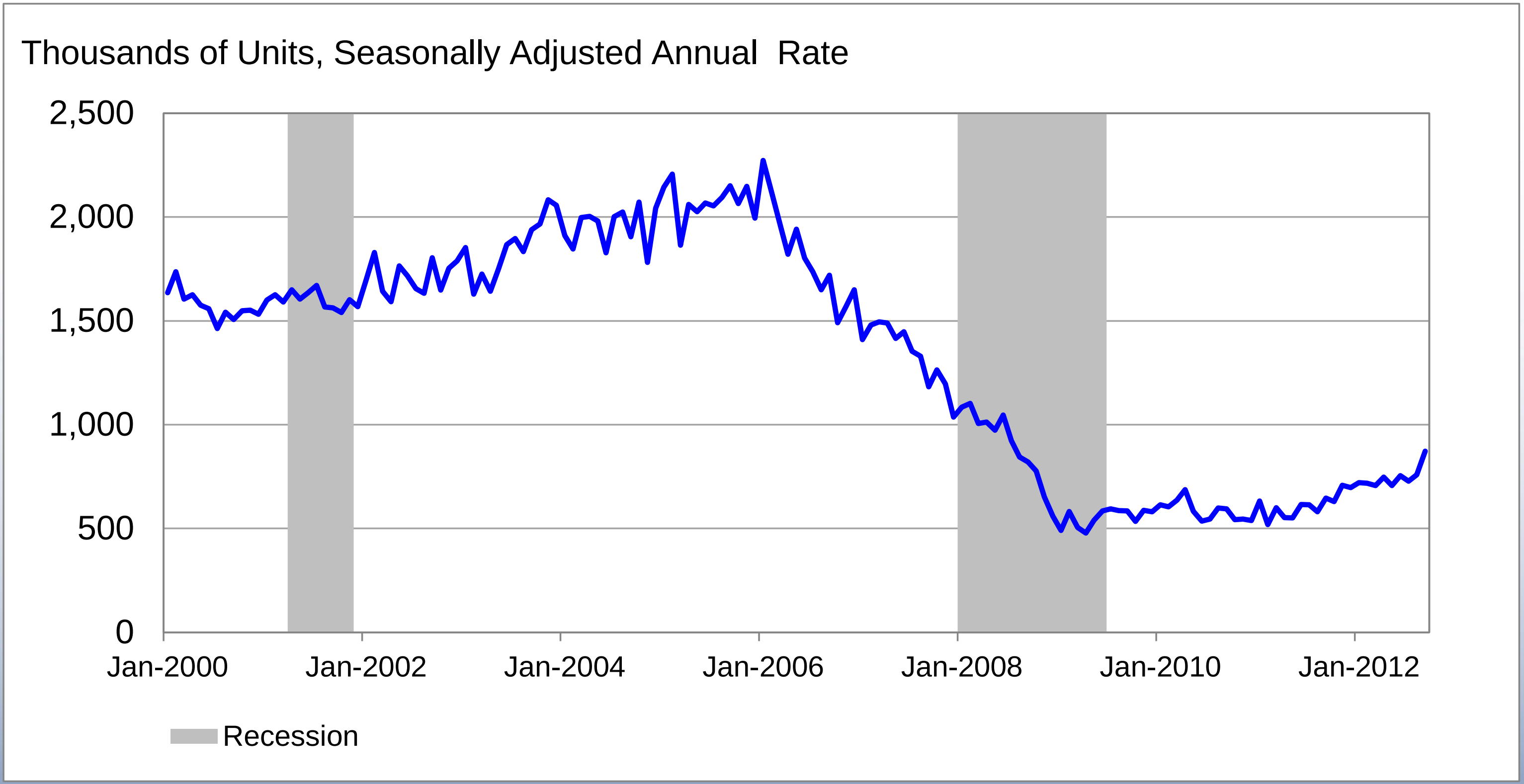


Note: Refinance applications account for 78% of applications on average over this period.

Source: Mortgage Bankers Association / Haver Analytics

Figure 3
Housing Starts

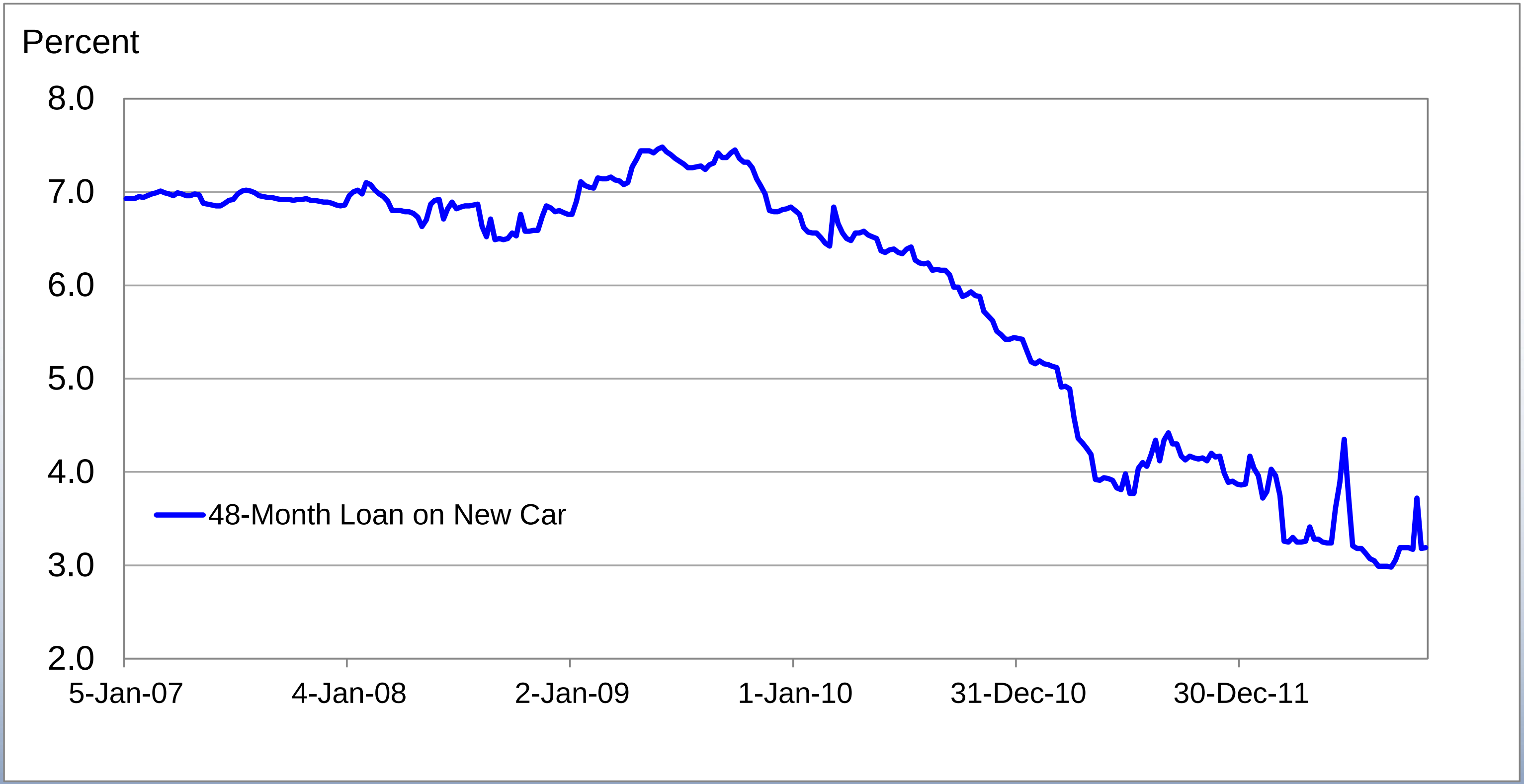
January 2000 - September 2012



Source: Census Bureau, NBER / Haver Analytics

Figure 4
Auto Loan Rates at Commercial Banks

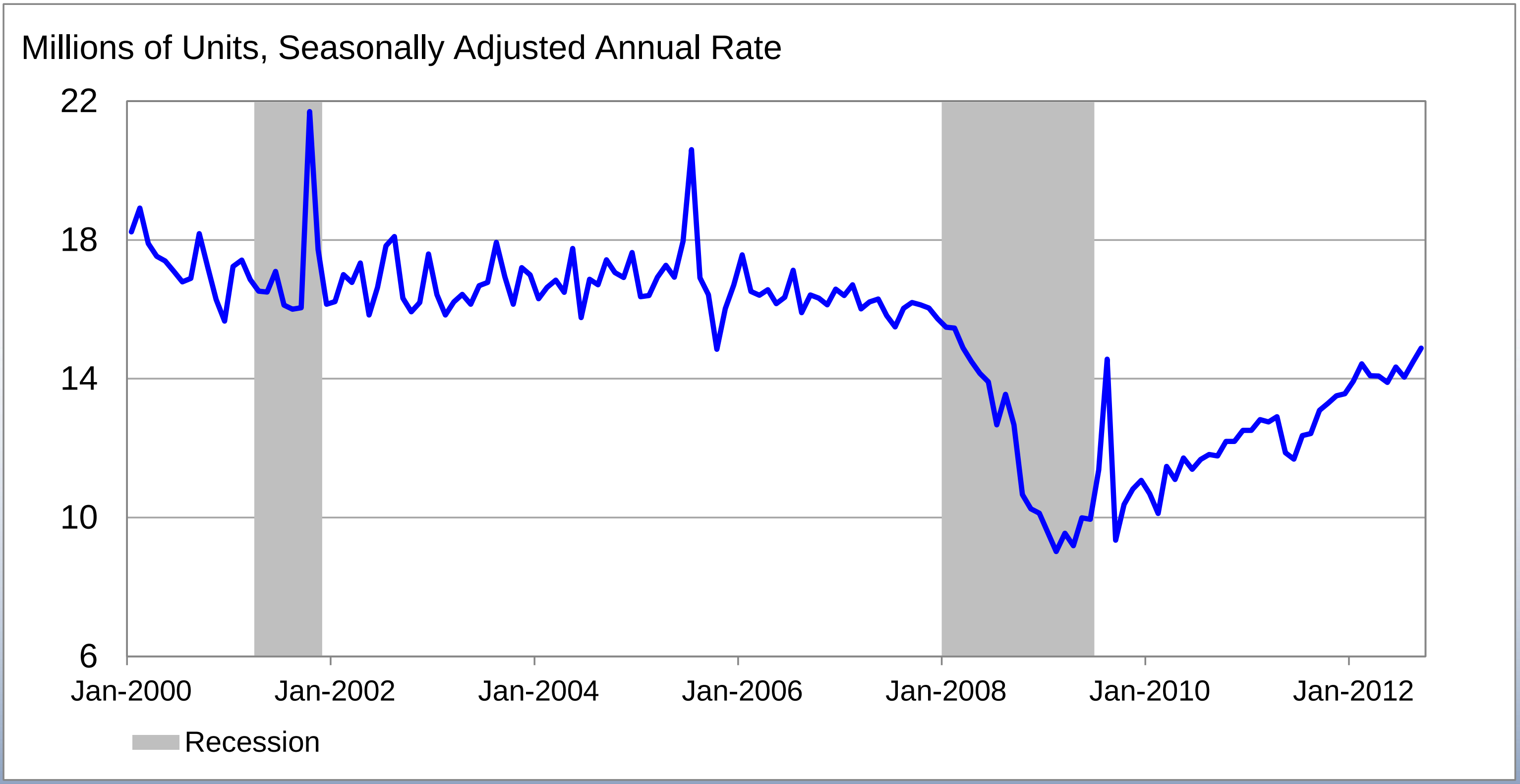
Weekly, January 5, 2007 - October 26, 2012



Source: Bankrate.com, Bloomberg

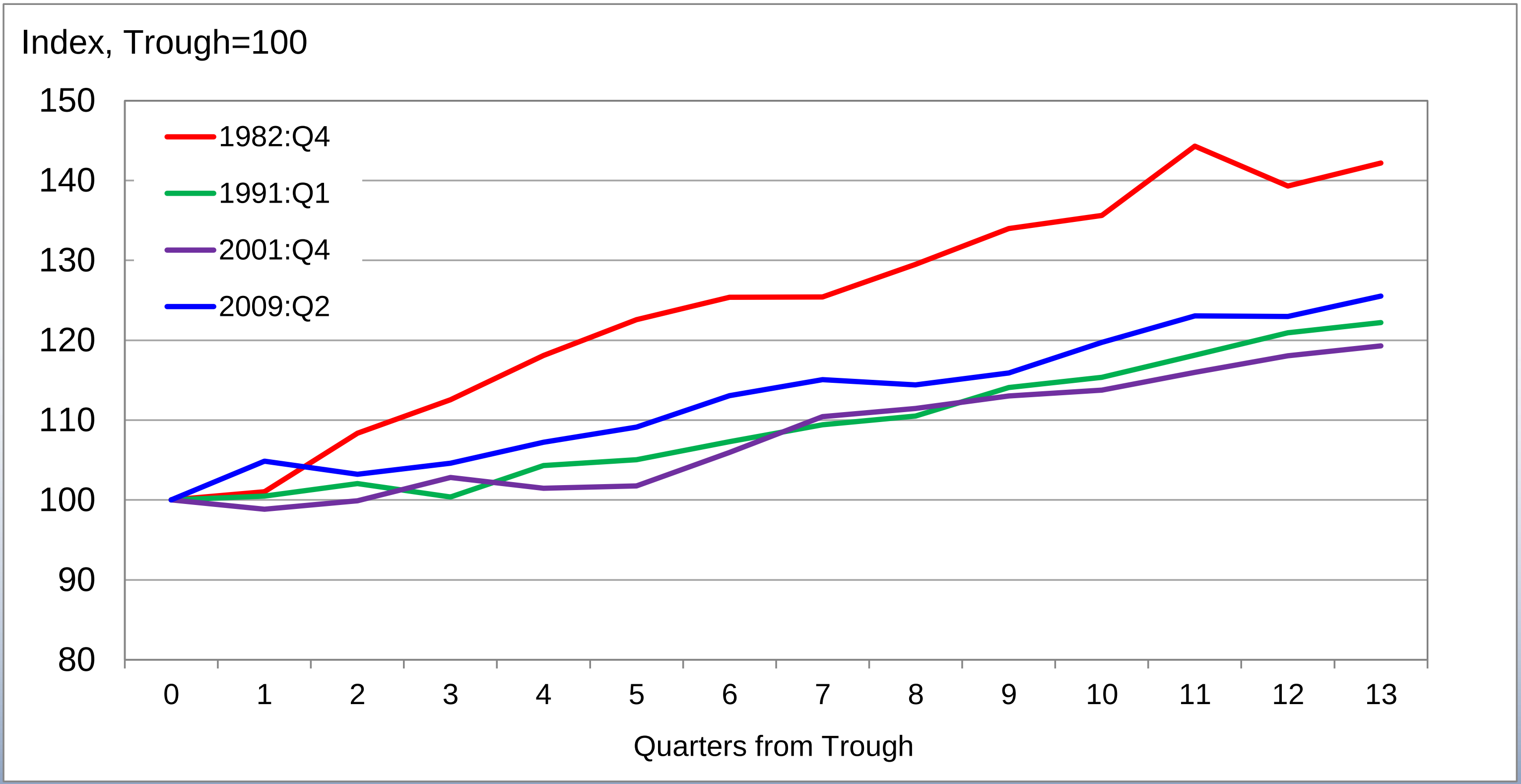
Figure 5
Auto and Light Truck Sales

January 2000 - September 2012



Source: BEA, NBER / Haver Analytics

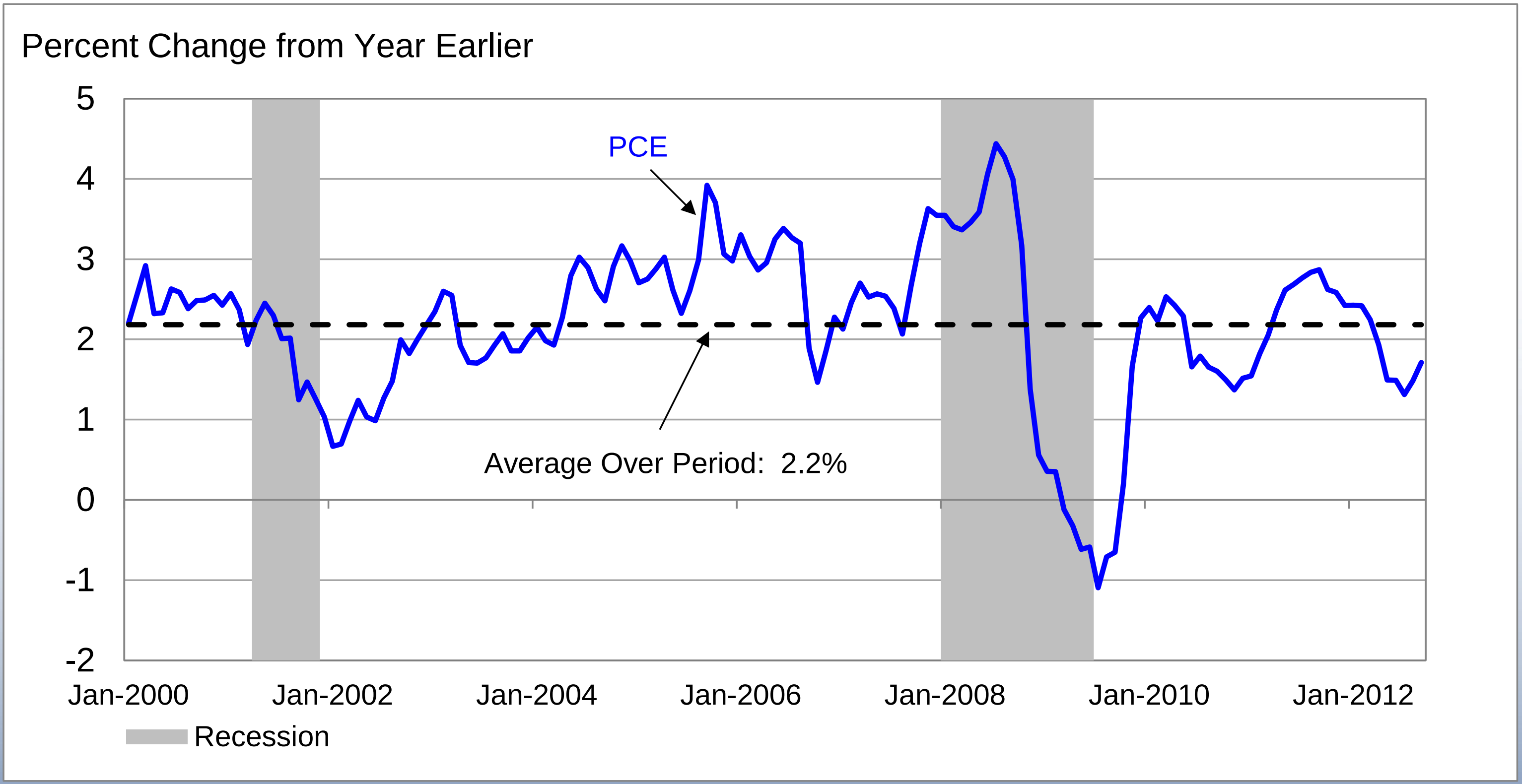
Figure 6
Growth in Real Consumer Durables from Trough of Last Four Recessions



Source: BEA, NBER / Haver Analytics

Figure 7
Inflation Rate: Change in Personal Consumption Expenditure (PCE) Price Index

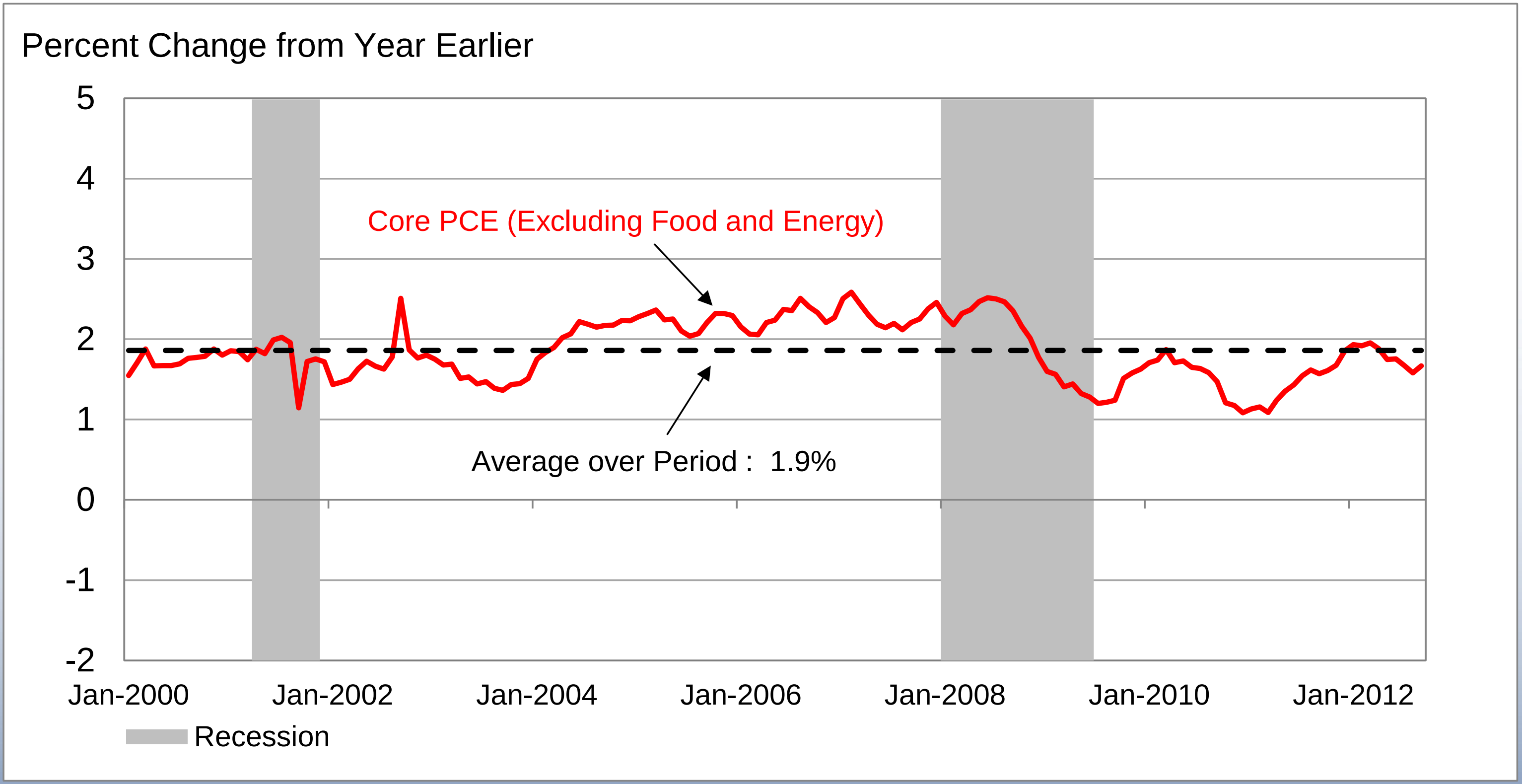
January 2000 - September 2012



Source: BEA, NBER / Haver Analytics

Figure 8
Inflation Rate: Change in Core Personal Consumption Expenditure (PCE) Price Index

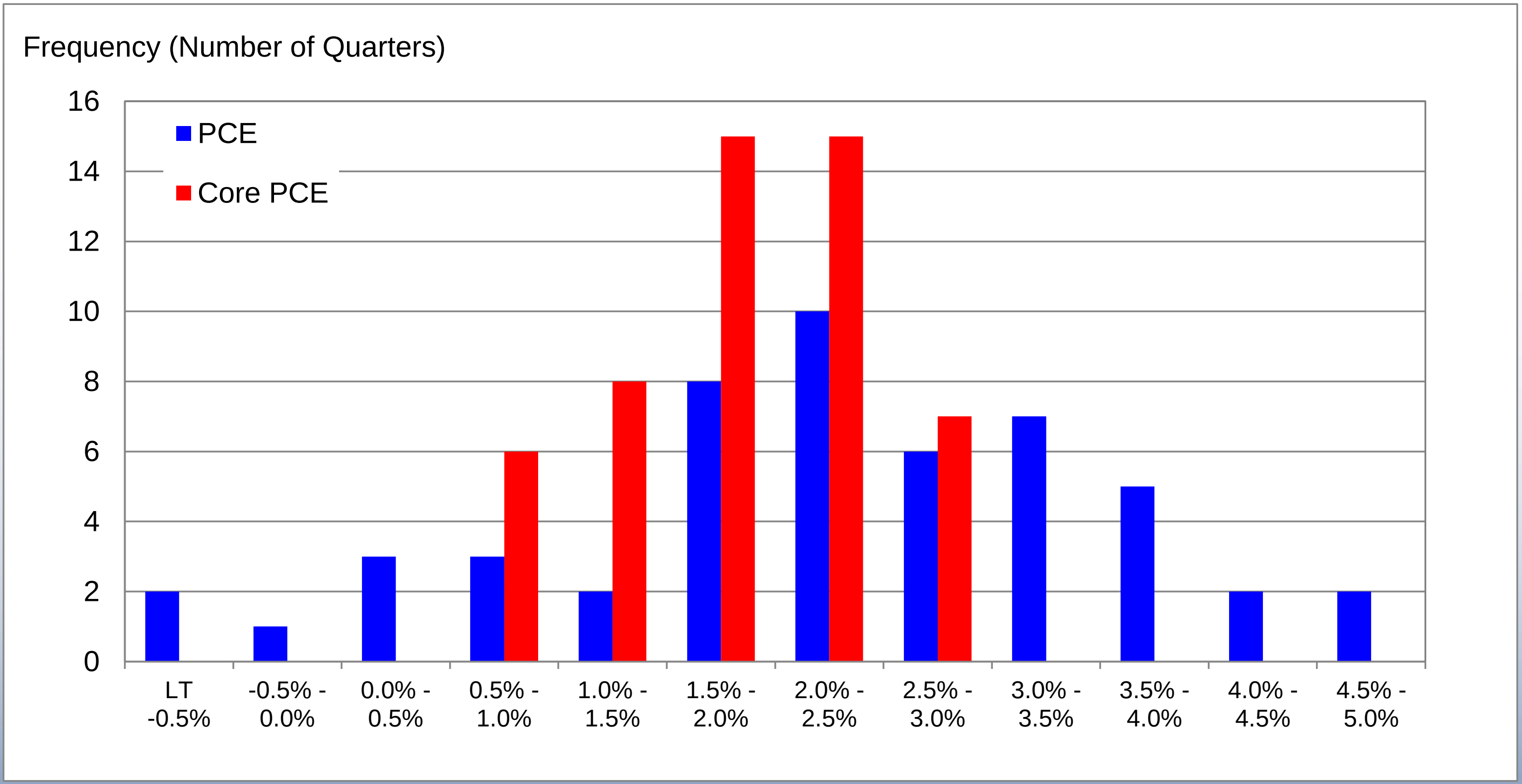
January 2000 - September 2012



Source: BEA, NBER / Haver Analytics

Figure 9
Distribution of PCE and Core PCE Inflation Rates
(Quarterly Changes at Annual Rates)

2000:Q1 - 2012:Q3



Source: BEA / Haver Analytics

Open-Ended MBS

- Automatic stabilizer
  - Negative shocks – could increase purchase period or amounts
  - Mitigate, but not fully or immediately offset large shocks, such as fiscal cliff
  - Positive shocks – shorten, shrink, or end purchase programs
- What determines if labor market improves substantially?

Figure 10
Economic Conditions at Last Easing and First Tightening by Fed during Past Three Recoveries

Following Three Recession Troughs – November 1982, March 1991, and November 2001

Economic Conditions as of Last Easing				
Date of Recession Trough	Date of Last Easing	Unemployment Rate (%)	Monthly Average Job Growth over Past 3 Months	PCE Inflation Rate % Change from Year Earlier
November 1982	August 21, 1986	7.0	116,700	2.4
March 1991	September 4, 1992	7.6	90,300	3.1
November 2001	June 25, 2003	6.1	-90,300	1.9
Economic Conditions as of First Tightening				
Date of Recession Trough	Date of First Tightening	Unemployment Rate (%)	Monthly Average Job Growth over Past 3 Months	PCE Inflation Rate % Change from Year Earlier
November 1982	January 5, 1987	6.6	192,300	2.3
March 1991	February 4, 1994	6.6	279,300	1.9
November 2001	June 30, 2004	5.6	298,700	2.8

Source: Federal Reserve Board, BLS, BEA, NBER / Haver Analytics

Conditions to End Easing

- End of easing quite different across cycles
- No single variable captures inflationary pressures or labor market conditions
- Future path of inflation and unemployment can be quite uncertain
- Given lack of historical experience of unwinding large balance sheets, need to be attuned to unintended consequences

My Preference for Threshold

- Continue asset purchase at least until the unemployment rate reaches 7.25 percent as long as inflation is contained
- Lift short-term rates off the zero bound after the unemployment rate reaches 6.5 percent, as long as inflation is contained

Conclusion

- Economy improving slowly
  - Positive signs for the housing market
  - Positive signs for consumer spending
- Significant downside risks that could more than off-set monetary stimulus
- Policy is encouraging more economic growth than if we had not taken recent actions