UNLV CENTER FOR BUSINESS & ECONOMIC RESEARCH
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Why U.S. Monetary Policy Remains Easy

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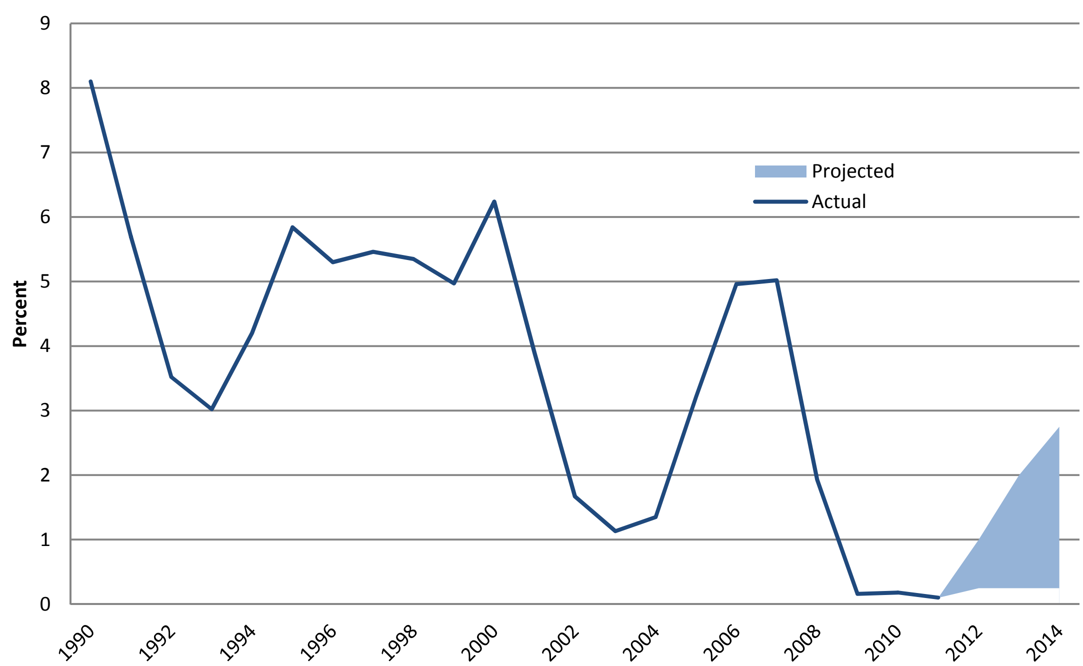
On January 25, 2012, the Federal Open Market Committee (FOMC) announced that it decided "to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014."[1] Committee members are divided about the exact targets that need to be sustained over the next few years, but the range of opinion includes rates that would maintain the stance of U.S. monetary policy about where it has been in place since 2009 (Chart 1).[2] With U.S. economic conditions improving, why are some committee members expecting the necessity of holding federal funds rates at such low levels for a prolonged period?

Chart 1: Federal Funds Rate



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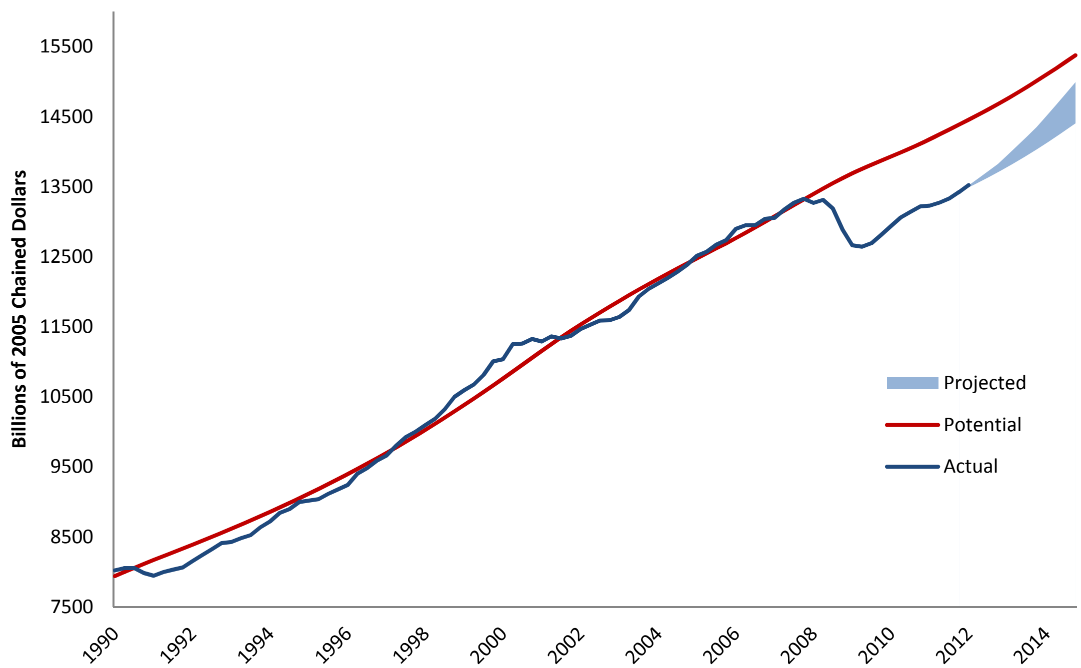
[1] See http://www.federalreserve.gov/newsevents/press/monetary/20120125a.htm. The FOMC is the policymaking arm of the U.S. Federal Reserve System (Fed), which determines U.S. monetary policy. The federal funds rate is the interest rate at which banks loan reserves to each other. The federal funds rate is the target interest rate that the Fed manages by buying and selling U.S. Treasury Bills.

[2] See http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20120125.pdf.

U.S. Economic Activity below Potential

U.S. economic activity remains well below potential (Chart 2). In third quarter 2011, U.S. real GDP was 6.87 percent below potential. Even with the growth rates projected by the FOMC for the next few years, U.S. real gross domestic product (GDP) will remain 4.38 percent below potential by the end of 2013.[3] The committee's projections are consistent with a gap of 2.48 percent at year-end 2014. The FOMC's expectation that U.S. real GDP will continue to remain well below potential is one indication that the United States is experiencing low rates of resource utilization and will continue to do so for the next few years.

Chart 2: Real GDP

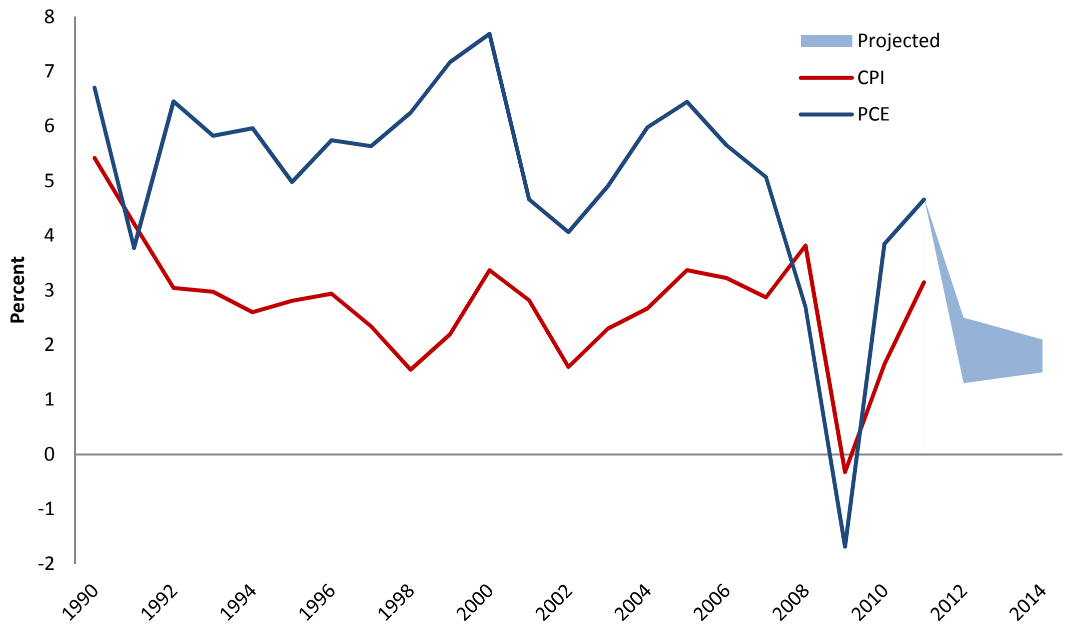


U.S. Inflation Is Subdued

The FOMC currently uses the core personal consumption expenditure (PCE) deflator as its policy target for inflation.[4] Another standard measure of inflation is the core consumer price index (CPI).[5] Chart 3 shows the annualized core inflation rates for both the CPI and the PCE, along with recent FOMC projections for PCE inflation.[6] As shown, the committee expects inflation to remain around 2 percent and below 3 percent through 2014.

[3] See http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20120125.pdf.
[4] The deflator for PCE measures the average increase in prices for domestic personal consumption as contained in GDP. The core measure excludes the volatile food and energy components.
[5] CPI measures the average increase in price for a basket of consumer goods. The core measure excludes the volatile food and energy components.
[6] See http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20120125.pdf.

Chart 3: Inflation



Monetary Policy Mostly Ineffective

Although the Federal Reserve System (Fed) has increased liquidity in the economy through low short-term interest rates and quantitative easing, uncertainty about the state of economic activity has meant that investment spending, lending and GDP have not responded very much. John Maynard Keynes called this situation a "liquidity trap."

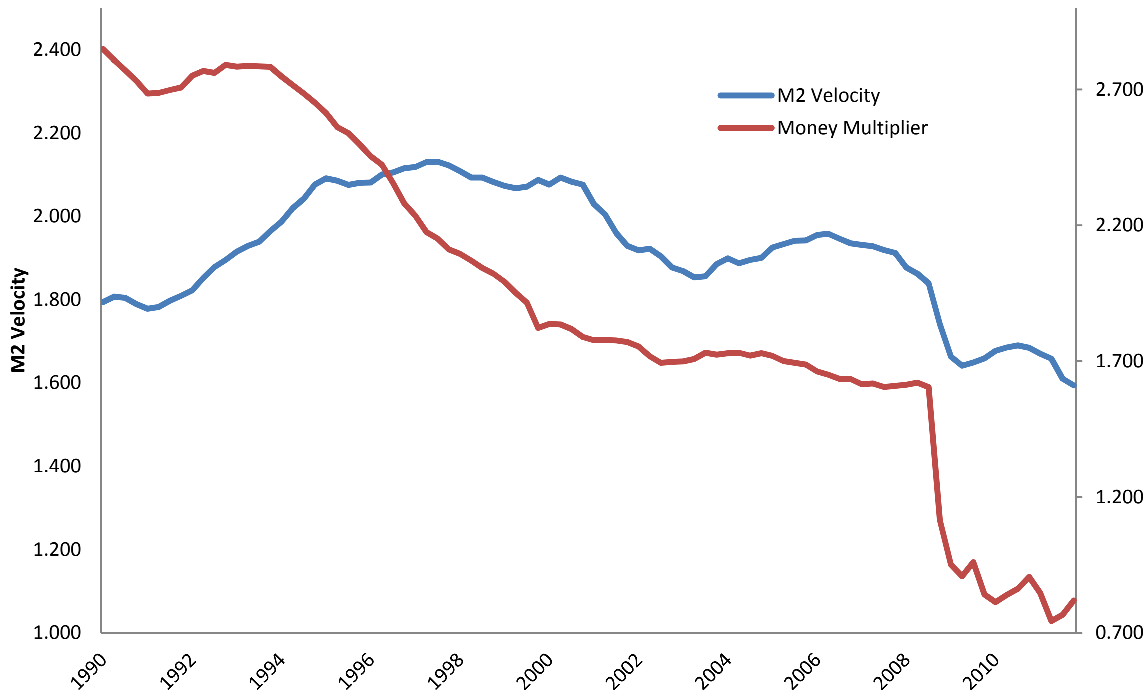
To examine this phenomenon, we consider the relationships between the monetary base and M2, and between M2 and GDP. The monetary base is a relatively narrow measure of money. It includes cash and reserve accounts that commercial banks hold at the Fed. Through the system of fractional reserves, the monetary base supports broader monetary aggregates, such as M2. M2 includes the monetary base plus checking and savings accounts.

As shown in Chart 4, the relationship between M2 and the economy has weakened considerably even with a recovery underway. The money multiplier, which measures the extent to which the monetary base is used to create more money, has dropped considerably. As the Fed tries to push more liquidity into the economy through the monetary base, it is finding that the monetary base is not being translated into as much monetary growth.

In addition, the velocity of money, which measures the relationship between M2 and GDP, has dropped considerably. The lower velocity means that less economic activity is associated with each dollar of M2.

The liquidity trap means that although the Fed has increased financial liquidity in the market, the economy has not responded. Keynes' prescription for such a situation was stimulative fiscal policy—that is, boosting government deficit spending.

Chart 4: M2 Velocity and Money Multiplier



The Need for Nimble Monetary Policy

As the economic recovery gains traction, however, the relationships between the monetary base and M2 and between M2 and economic activity will also strengthen. Under normal economic conditions, the current amount of financial liquidity that the Fed has injected into the economy would support much higher economic activity and/or inflation. Although the FOMC currently sees a subdued outlook for inflation, it must be prepared to act quickly to remove any excess liquidity as the economy gains traction. Otherwise, the liquidity will quickly turn into inflationary pressure.

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