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March 2, 2012

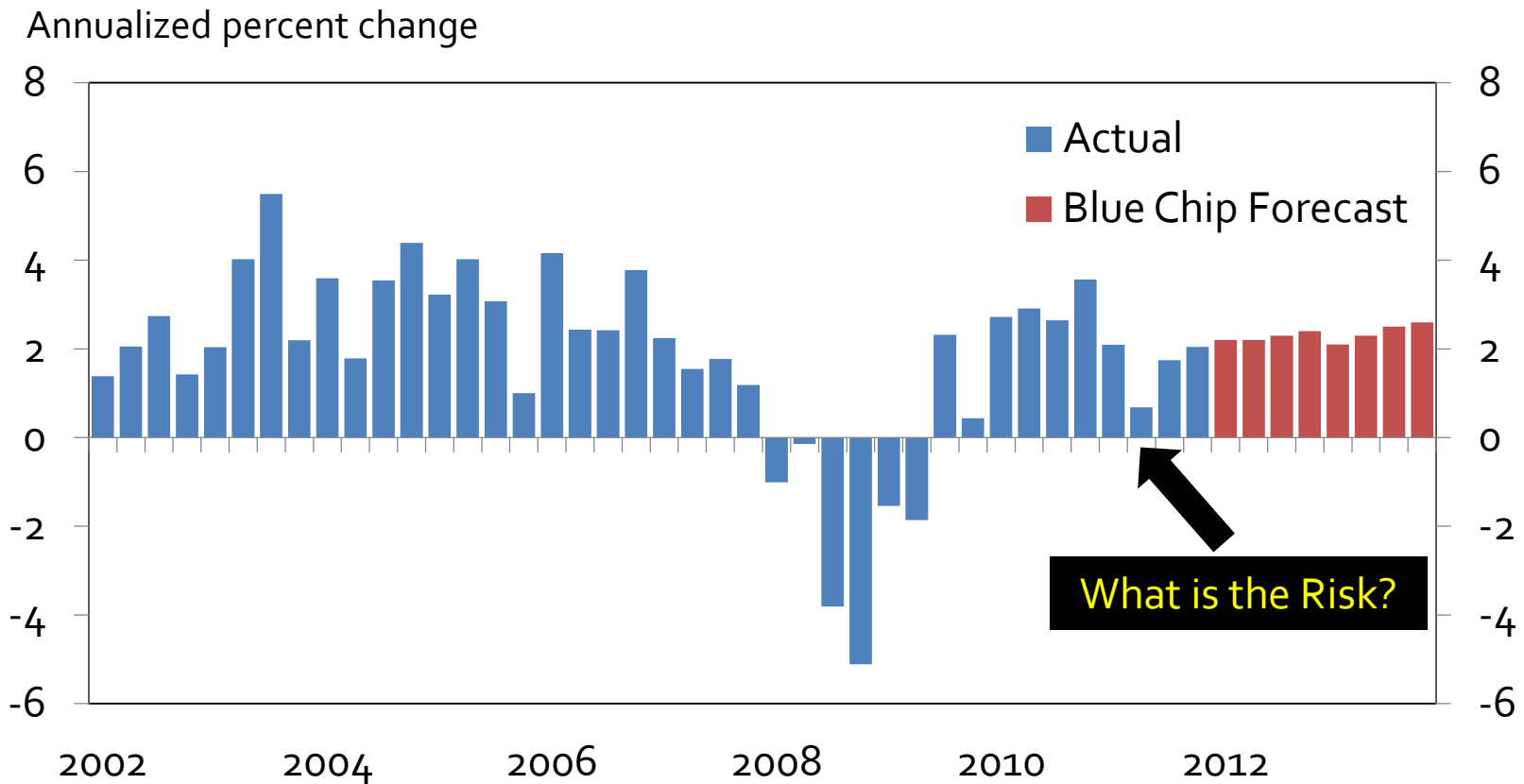
# Assumptions Matter



The views expressed are those of the author and do not necessarily reflect the opinions of the Federal Reserve Bank of Kansas City or the Federal Reserve System.

# C: Personal consumption is expected to advance moderately in 2012.

## U.S. Real Personal Consumption Growth

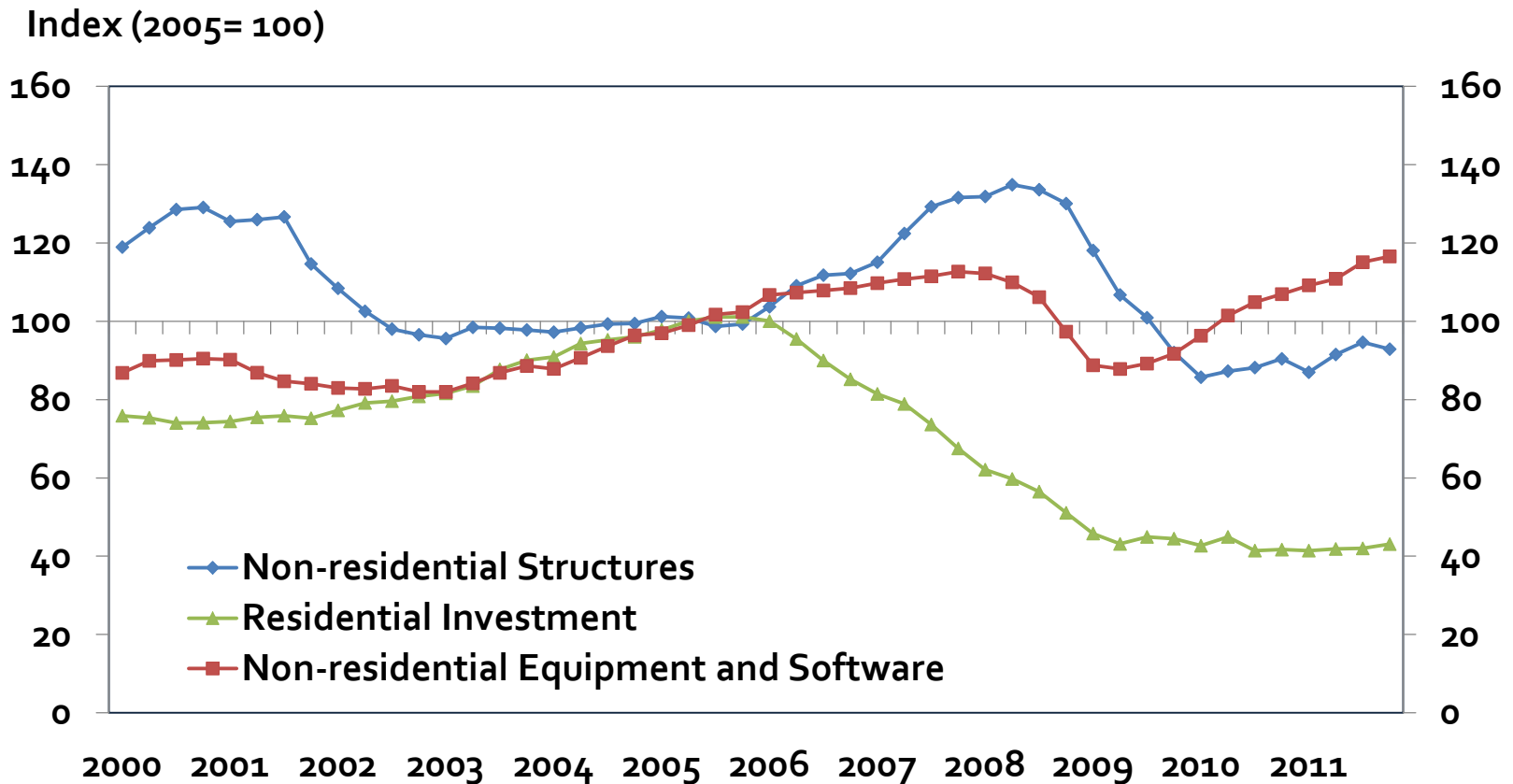


Source: Census Bureau and Blue Chip Economic Indicators, February 2012



# I: What will it take for a rebound in business and residential investment?

## U.S. Real Private Fixed Investment

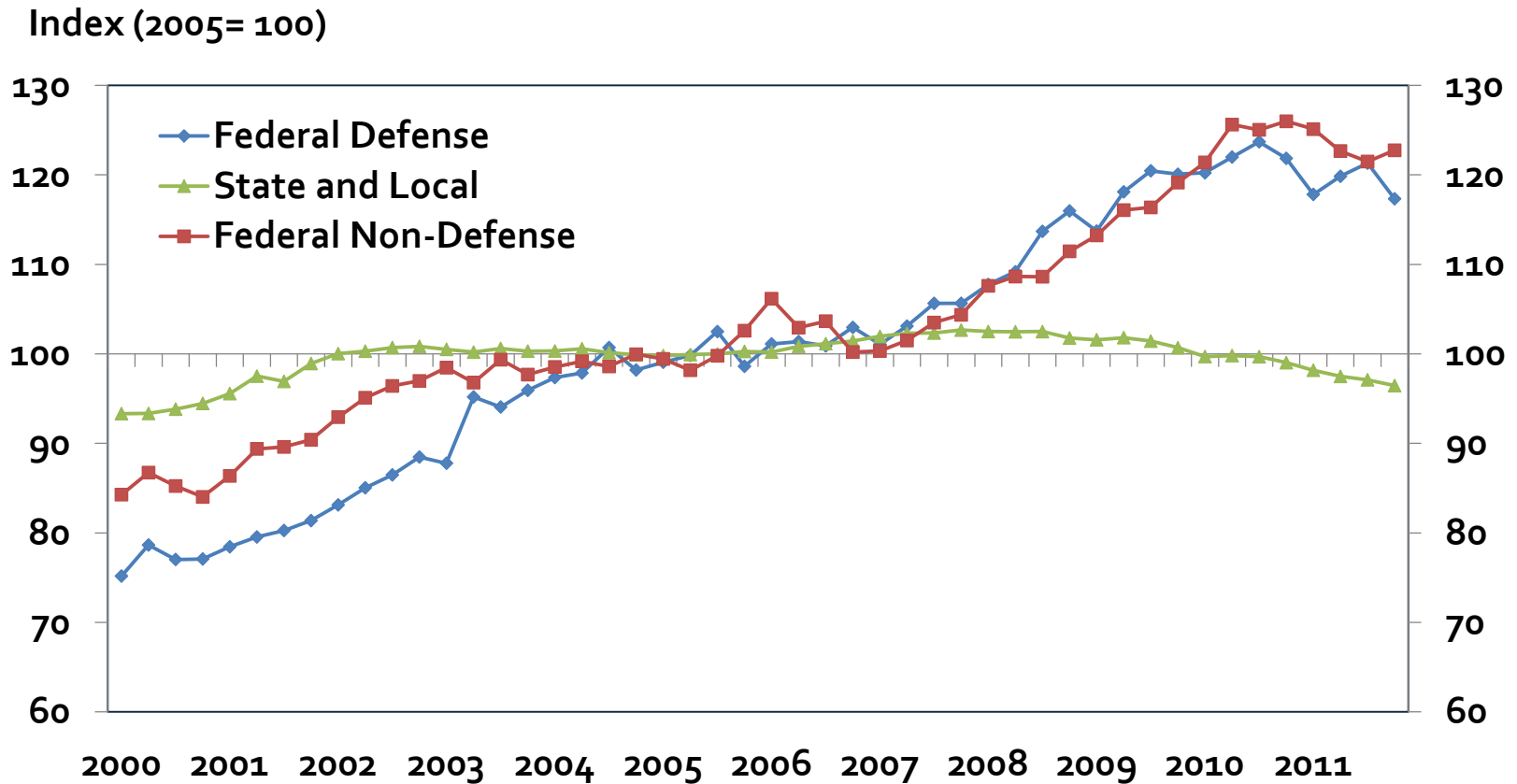


Source: Bureau of Economic Analysis



# G: What is the difference between federal, state, and local spending patterns?

## U.S. Government Spending

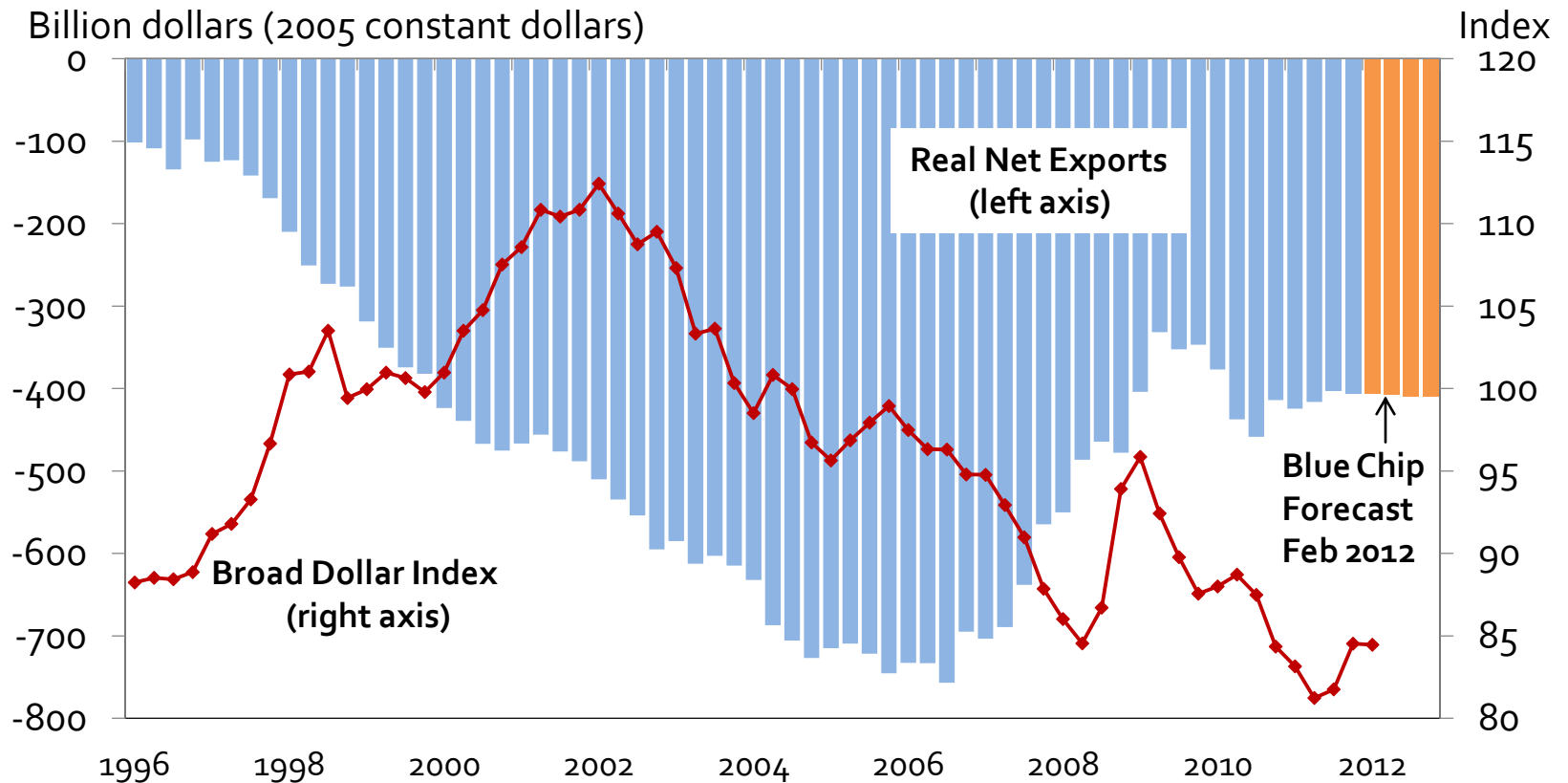


Source: Bureau of Economic Analysis



# X-M: Will a weak dollar cut our trade deficit?

## U.S. Real Net Exports of Goods and Services and Value of the Dollar



Source: Bureau of Economic Analysis, Federal Reserve Board of Governors, Blue Chip Economic Indicators



# The Goal: Foster Maximum Employment and Stable Prices

## Economic Projections of Federal Open Market Committee Members, Central Tendency, June 2011

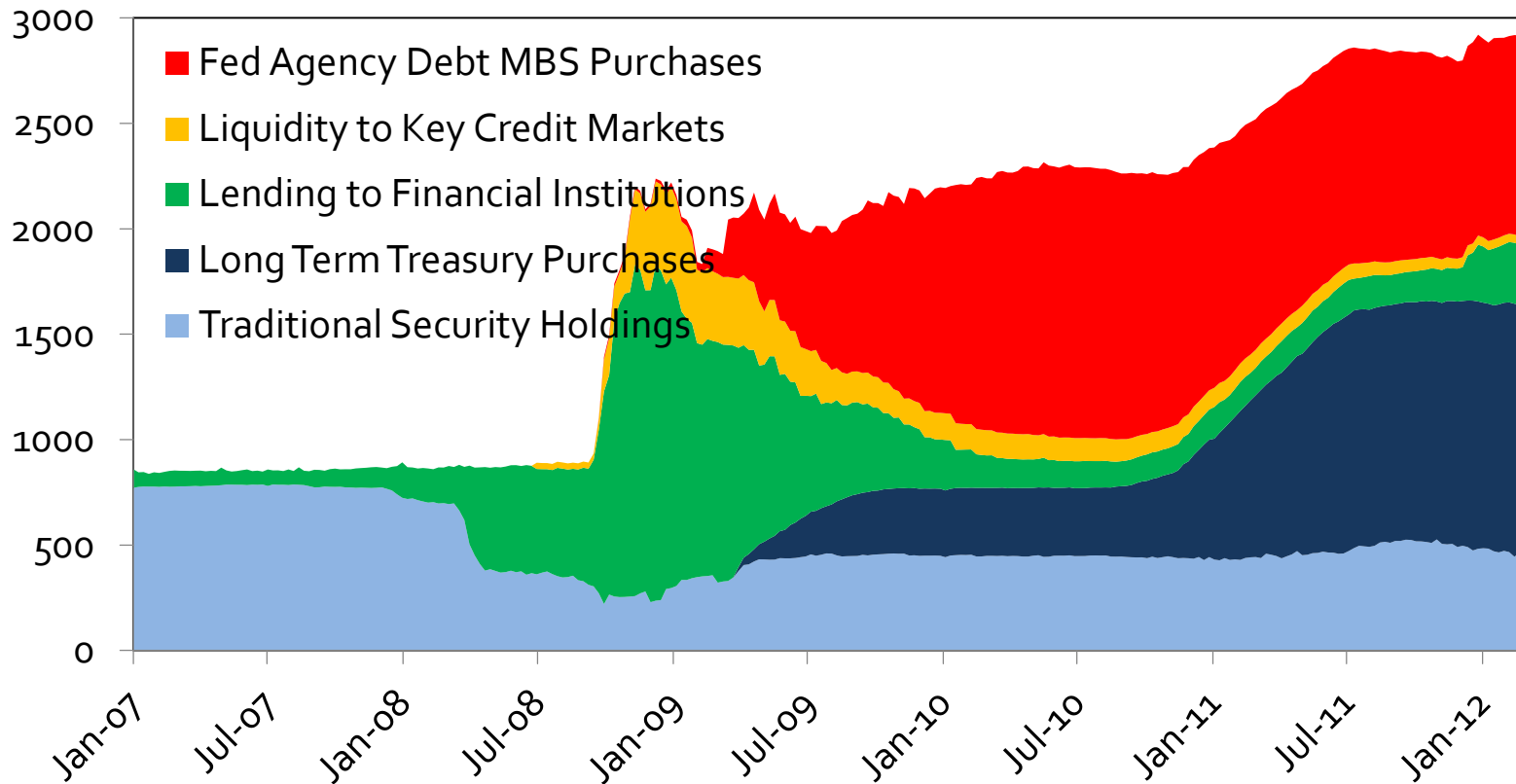
	Longer Run	2012	2013	2014
Real GDP Growth	2.3 to 2.6	2.2 to 2.7	2.8 to 3.2	3.3 to 4.0
Nov. 2011 proj.	2.4 to 2.7	2.5 to 2.9	3.0 to 3.5	3.0 to 3.9
Unemployment Rate	5.2 to 6.0	8.2 to 8.5	7.4 to 8.1	6.7 to 7.6
Nov. 2011 proj.	5.2 to 6.0	8.5 to 8.7	7.8 to 8.2	6.8 to 7.7
PCE Inflation	2.0	1.4 to 1.8	1.4 to 2.0	1.6 to 2.0
Nov. 2011 proj.	1.7 to 2.0	1.4 to 2.0	1.5 to 2.0	1.5 to 2.0

Source: Federal Reserve Board of Governors



# Federal Reserve Balance Sheet: Assets

Billion Dollars

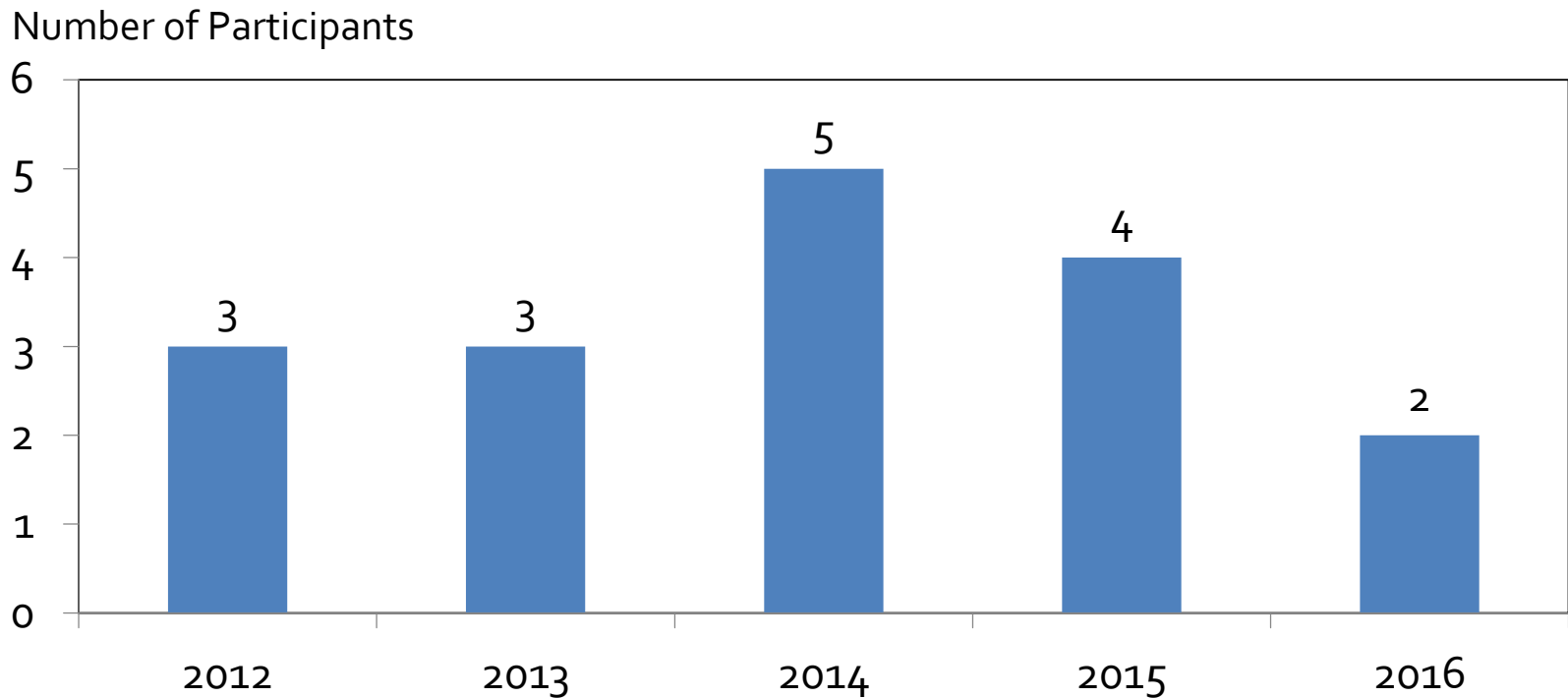


Source: Federal Reserve Bank of Cleveland



# When will interest rates turn higher?

## Overview of Federal Open Market Committee (FOMC) Participants Assessments of Appropriate Monetary Policy (Appropriate Timing of Policy Firming)



Source: Federal Reserve Board of Governors





# Audience Question

**If Economists Use the Same Data  
and are Taught the Same Theory,  
*Why Do they Come Up with Different Answers?***



# The Taylor Rule

Fed Funds Rate = Equilibrium Real Interest Rate + Inflation Rate + Deviation of Inflation from Target + Output Gap

$$i_t = rr^* + p_t + \beta(p_t - p^*) + \gamma(y_t - y_t^*)$$

## What Can Economists Debate in the Taylor Rule?

- Equilibrium real interest rate
- Inflation rate measure
- Inflation target
- Potential GDP
- Weights on inflation and output gap

George A. Kahn. 2010 "Taylor Rule Deviations and Financial Imbalances" *Economic Review*, Federal Reserve Bank of Kansas City, Second Quarter  
<http://www.kansascityfed.org/Publicat/EconRev/PDF/10q2Kahn.pdf>



# Despite the rules, there are challenges?

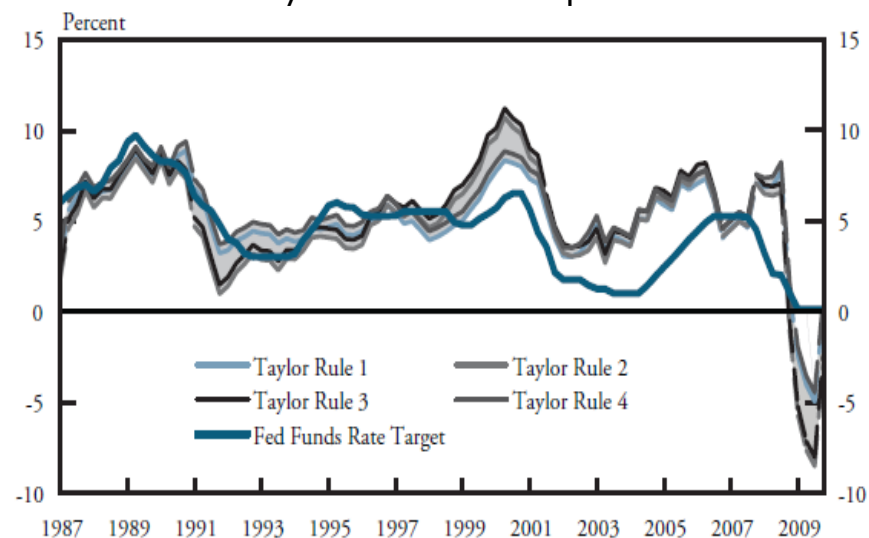
- There are many different specifications.

(House rules)



- Was the FOMC following a rule after 1999?

Taylor Rule Prescriptions



George A. Kahn. 2010 "Taylor Rule Deviations and Financial Imbalances"  
*Economic Review*, Federal Reserve Bank of Kansas City, Second Quarter  
<http://www.kansascityfed.org/Publicat/EconRev/PDF/10q2Kahn.pdf>



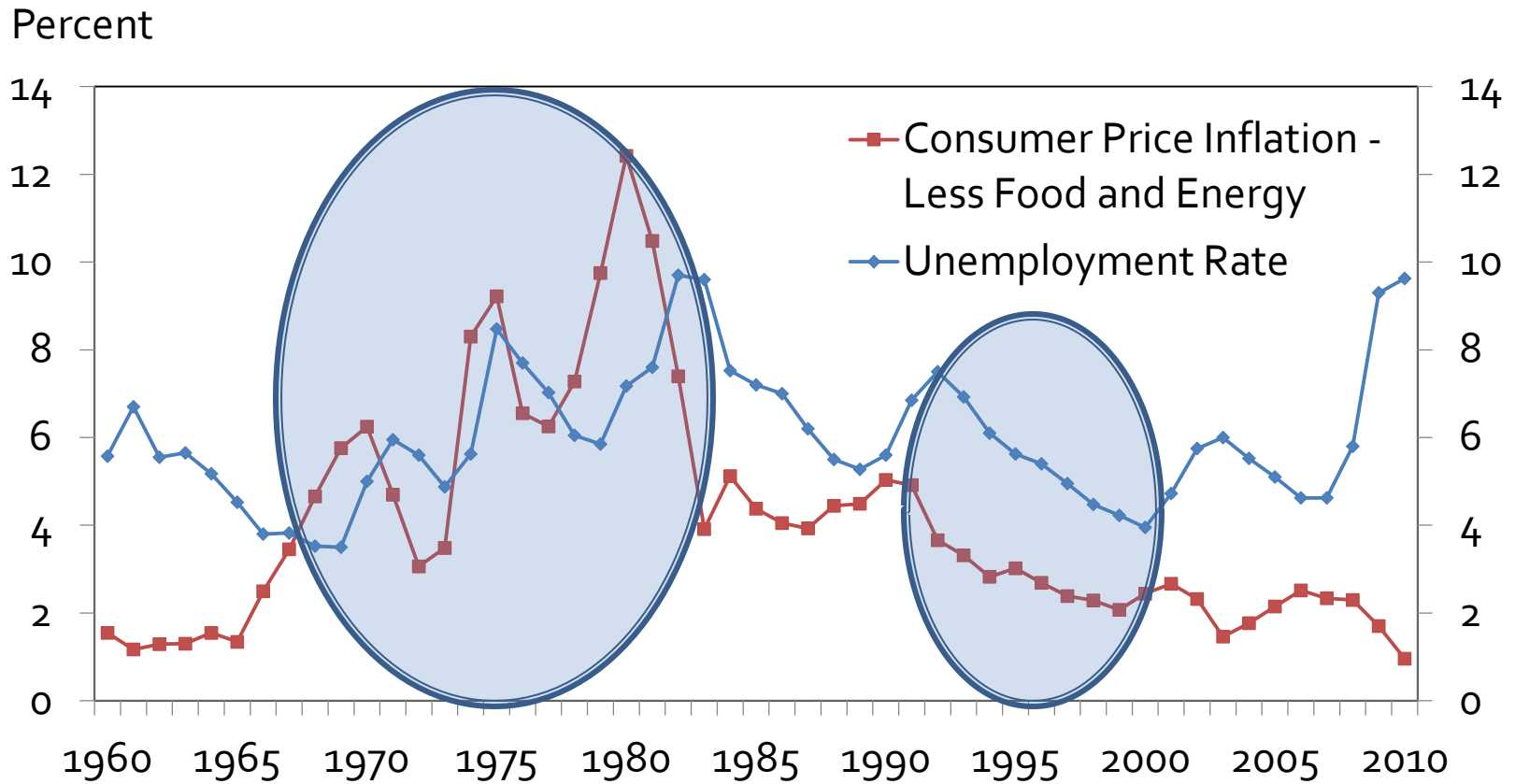
# The Balancing Act of Monetary Policy



Foundation based on the Phillips Curve

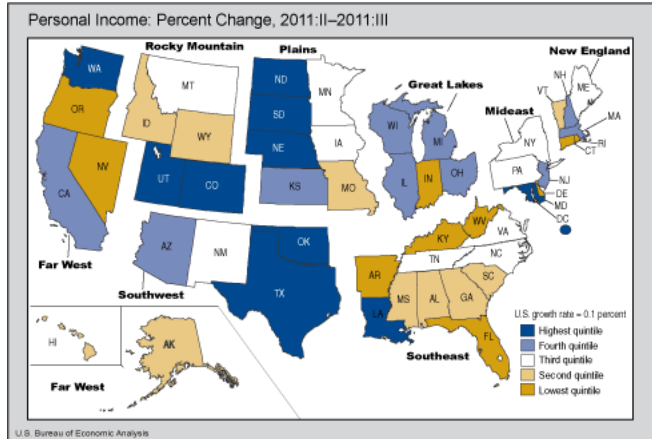


# Is the Phillips Curve Dead or Alive?

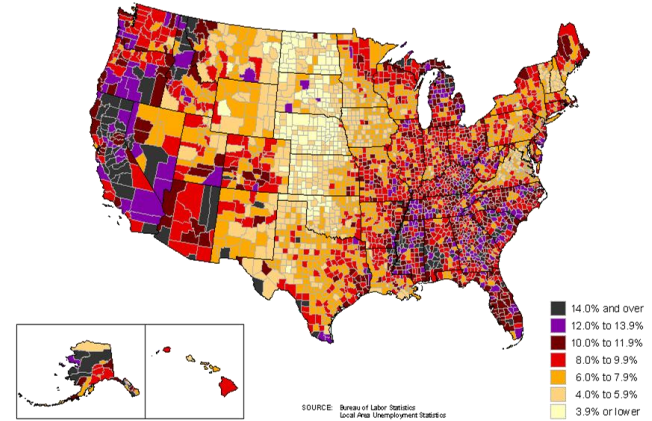


# Local economies influence perspectives

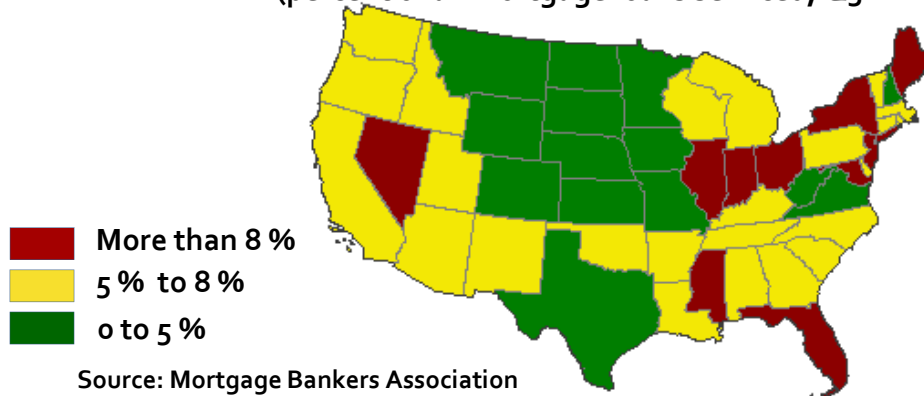
## Personal Income Gains



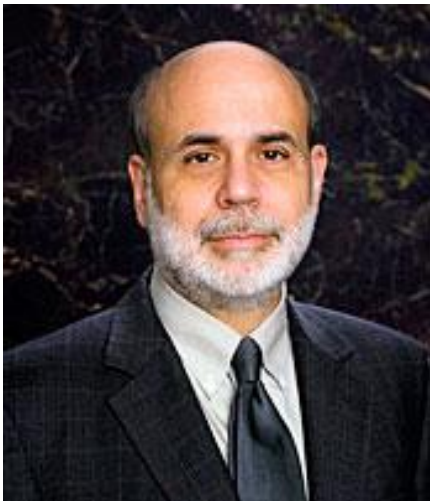
## Unemployment Rate - 2011



## Seriously Delinquent Mortgage Loans (percent of all mortgage loans serviced, Q3 2011)



# Memories or Life Experiences Influence Perspectives



Federal Reserve Chairman Ben Bernanke  
Research on the Great Depression

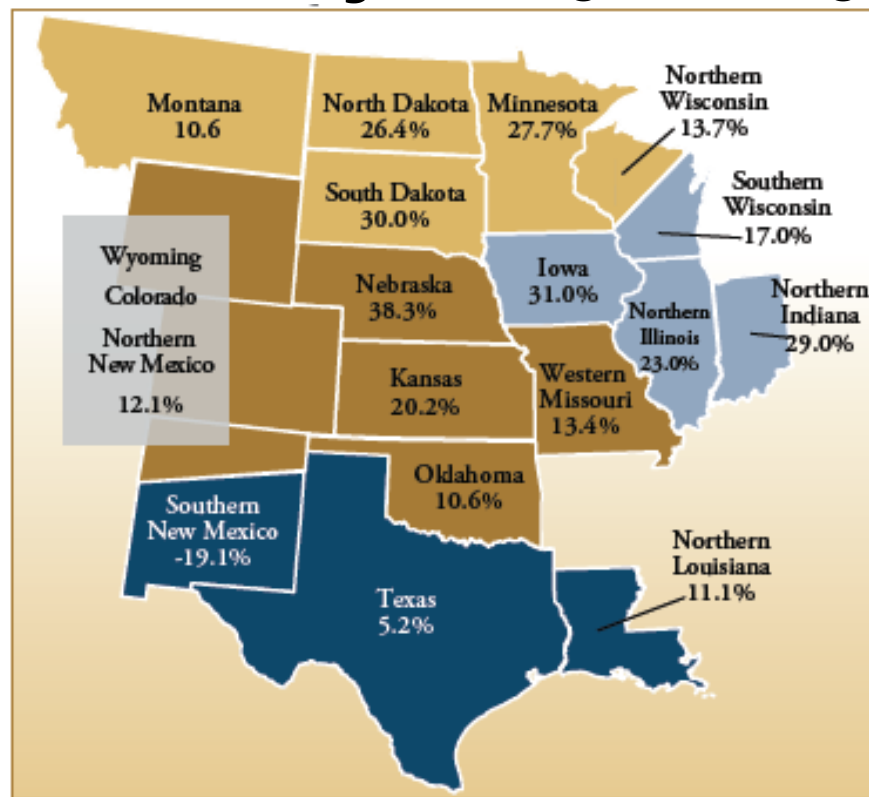


Former FRBKC President Thomas Hoenig  
Closed Banks in the 1980s  
*Dissented 8 times in 2010*



# The economic industry shapes perspectives.

## Non-irrigated Cropland Values (Percent change 2010:Q3 to 2011:Q3)

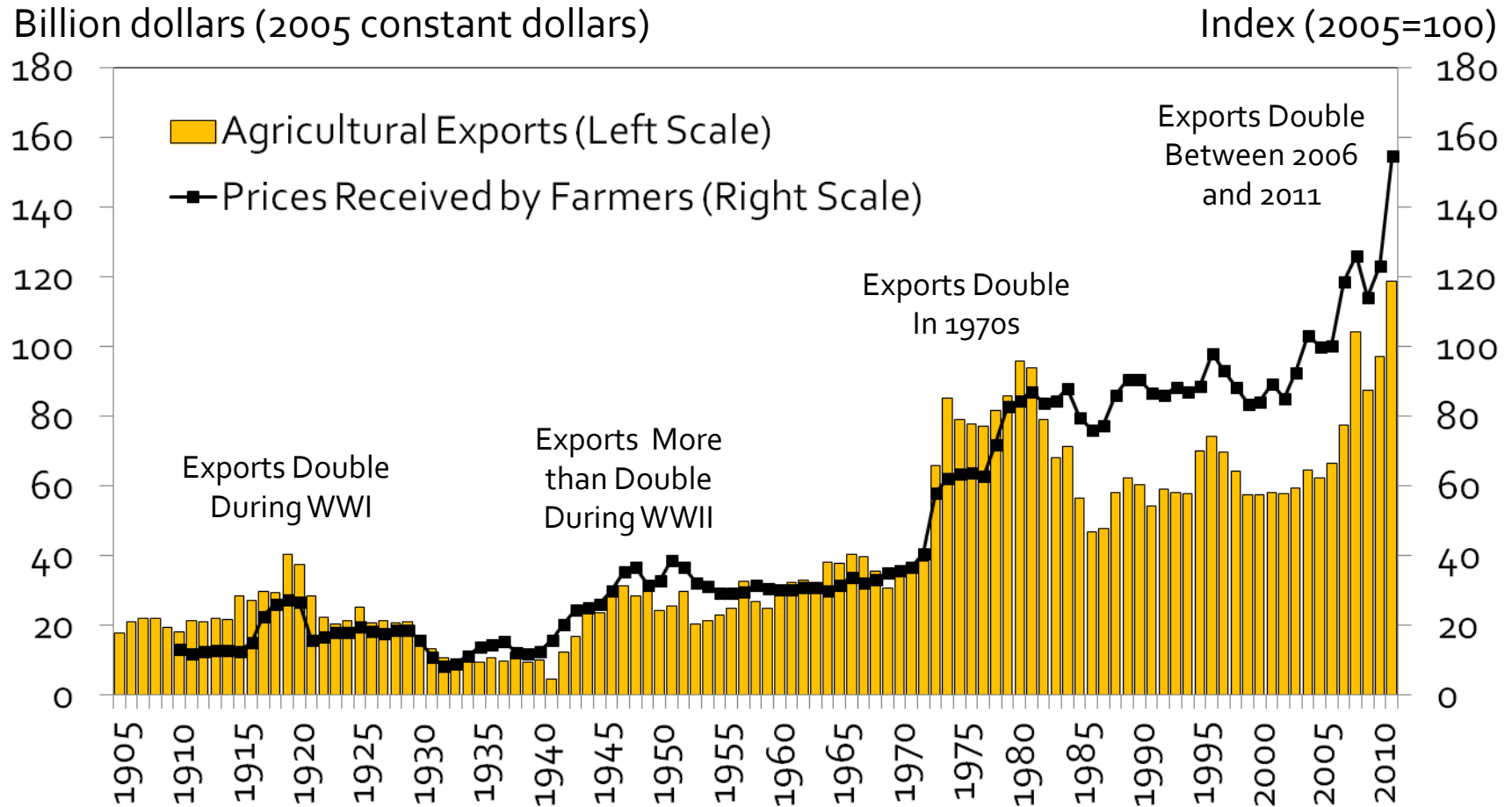


Source: Agricultural Finance Databook, FRBKC





# U.S. Agricultural Exports and Farm Prices



Source: Henderson, Gloy, and Boehlje (2011) "Agriculture's Boom-Bust Cycles: Is This Time Different" *Economic Review*, Federal Reserve Bank of Kansas City.



# Audience Question

**Doesn't the Federal Reserve's  
large balance sheet  
mean inflation is coming?**



**Inflation is based on money and velocity.**

## Quantity Theory of Money

$$\text{Price} = \frac{\text{Money} * \text{Velocity}}{\text{Quantity}}$$

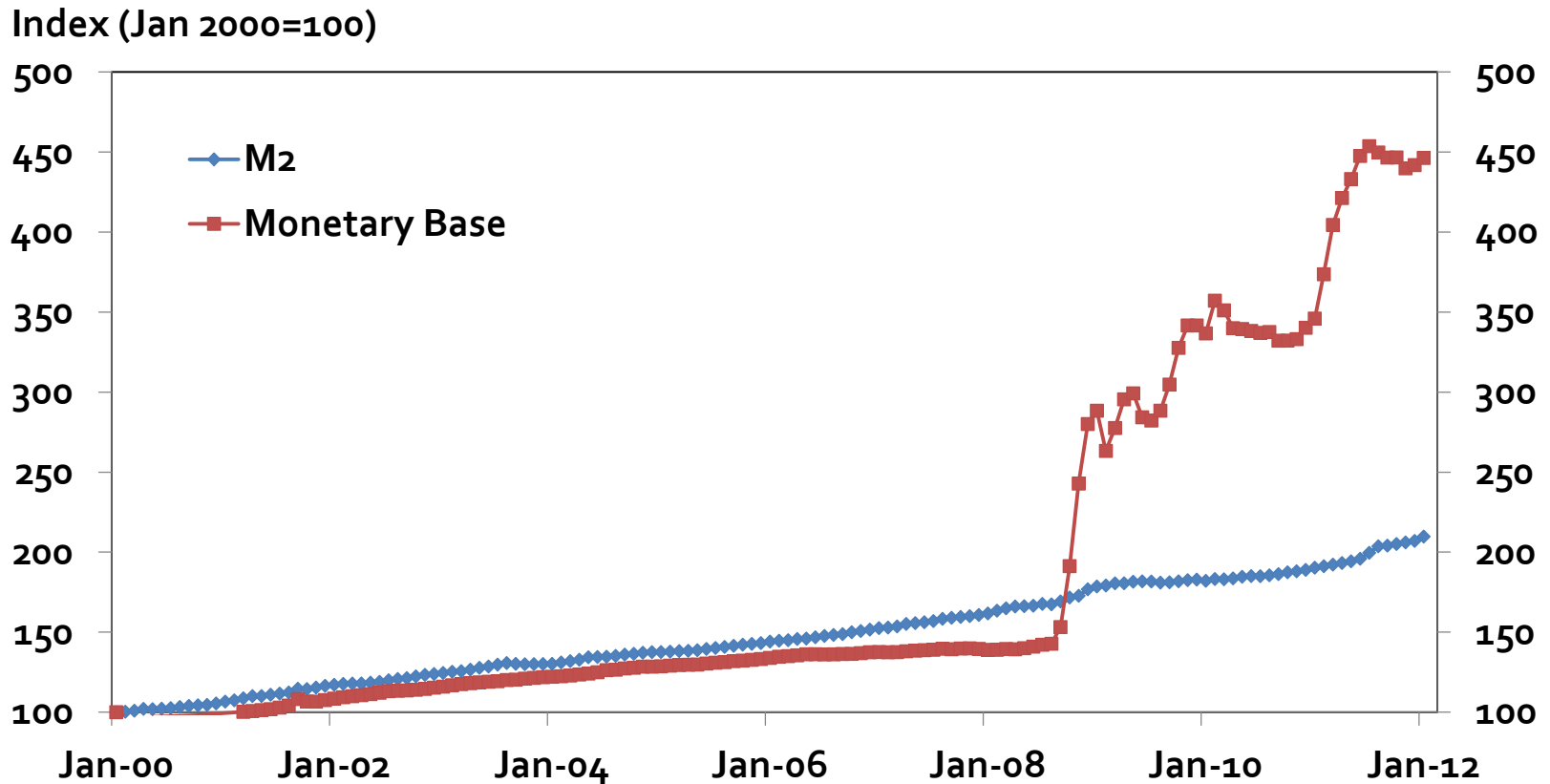
## Definition of Inflation:

Too much money  $M \uparrow$   
chasing  $V \uparrow$   
too few goods  $Q \downarrow$



# The Monetary Base is not Money Supply

## Growth in Monetary Aggregates



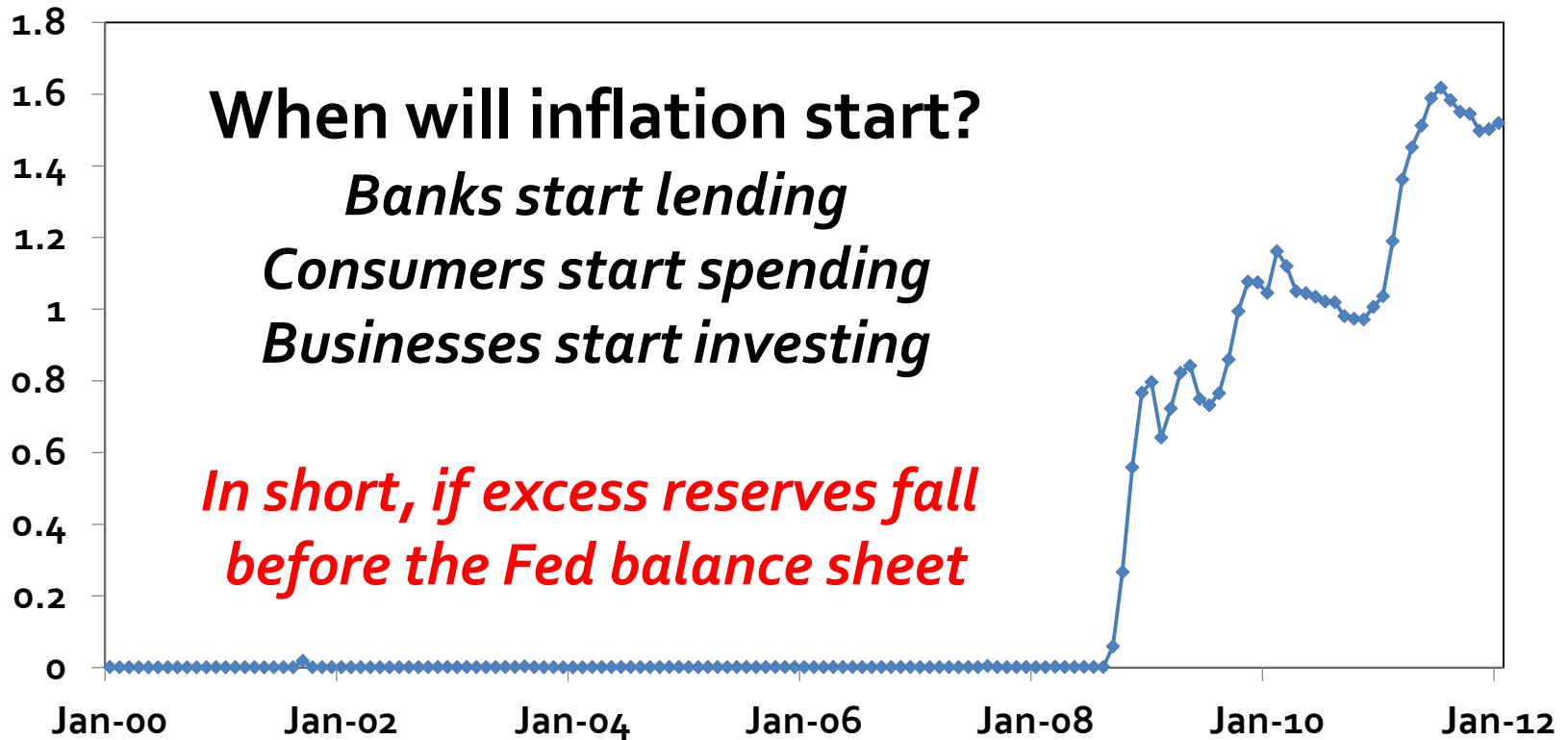
Source: Federal Reserve Board of Governors



# Banks are holding monetary base in excess reserves

## Excess Reserves in Depository Institutions

Trillion dollars



Source: Federal Reserve Board of Governors



# Conclusion

- Economic activity is expected to improve,
  - Inflation is expected to remain well-anchored,
  - the unemployment rate could remain high.
- Monetary policy is art, not science.
- In economics, assumptions matter.

