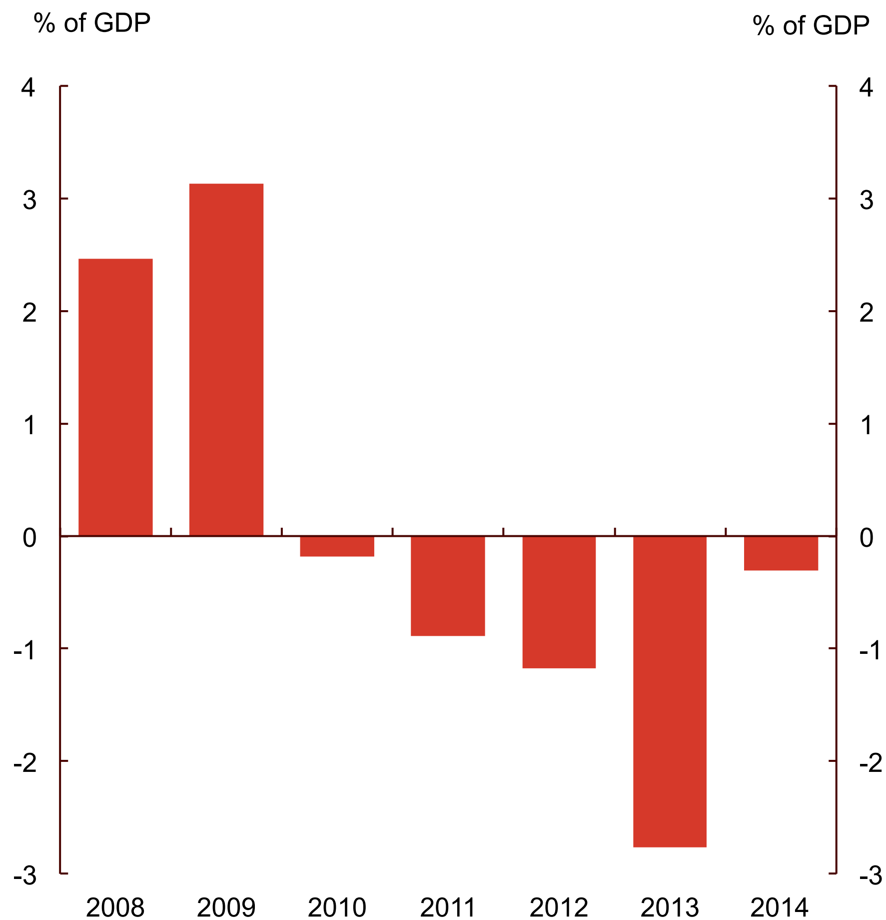
Fiscal consolidation is driving the outlook

Negotiations on the debt limit in 2011 and "fiscal cliff" a year ago led to significant fiscal tightening

Further initiatives to tighten fiscal policy are not expected in 2014

Federal Budget Balance (% of GDP)

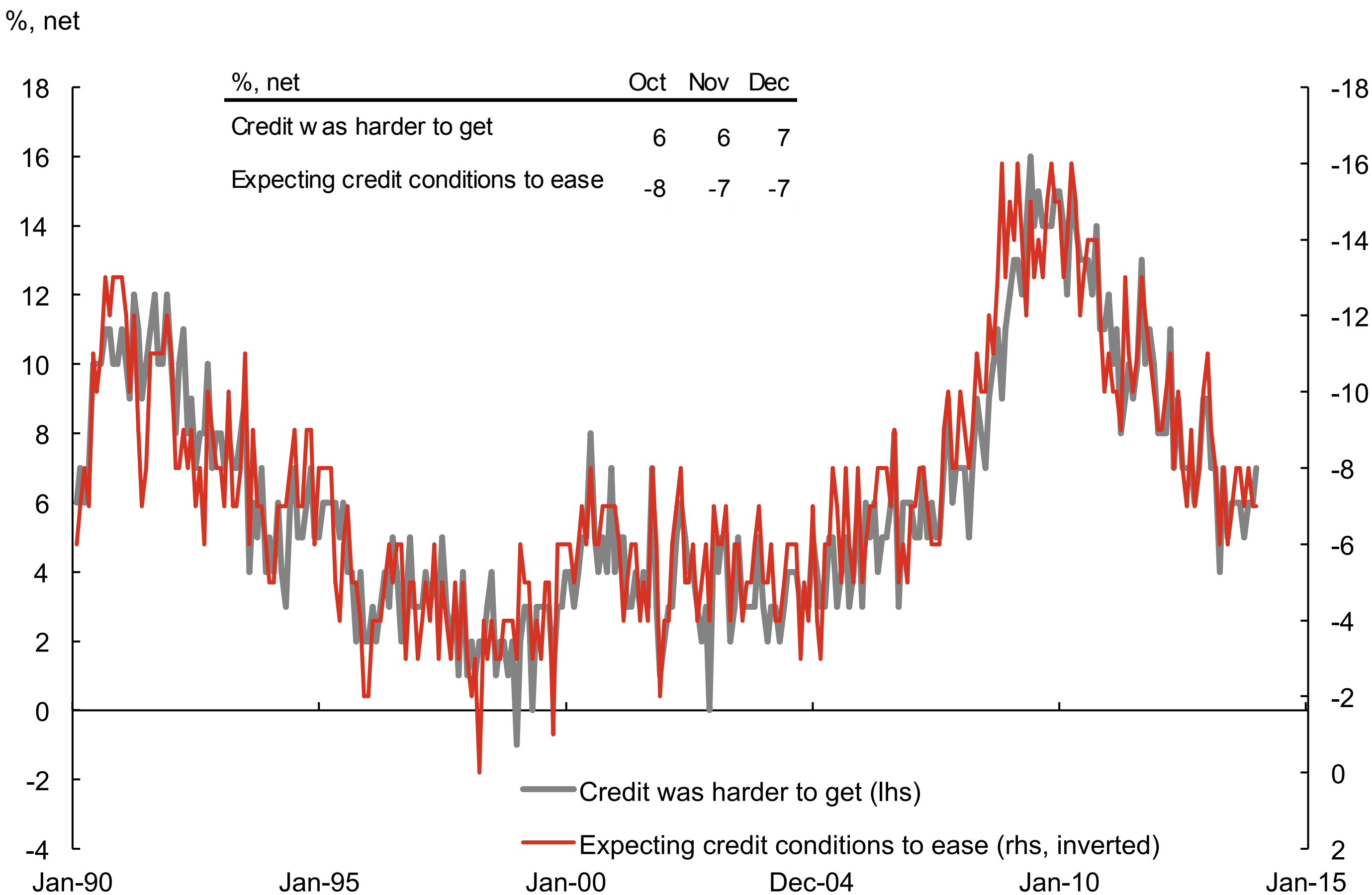
Change in Cyclically Adjusted Budget Balance (% of GDP)



Source: CBO, IMF, OECD, and Nomura Economics

Credit conditions are easing

Small business access to credit

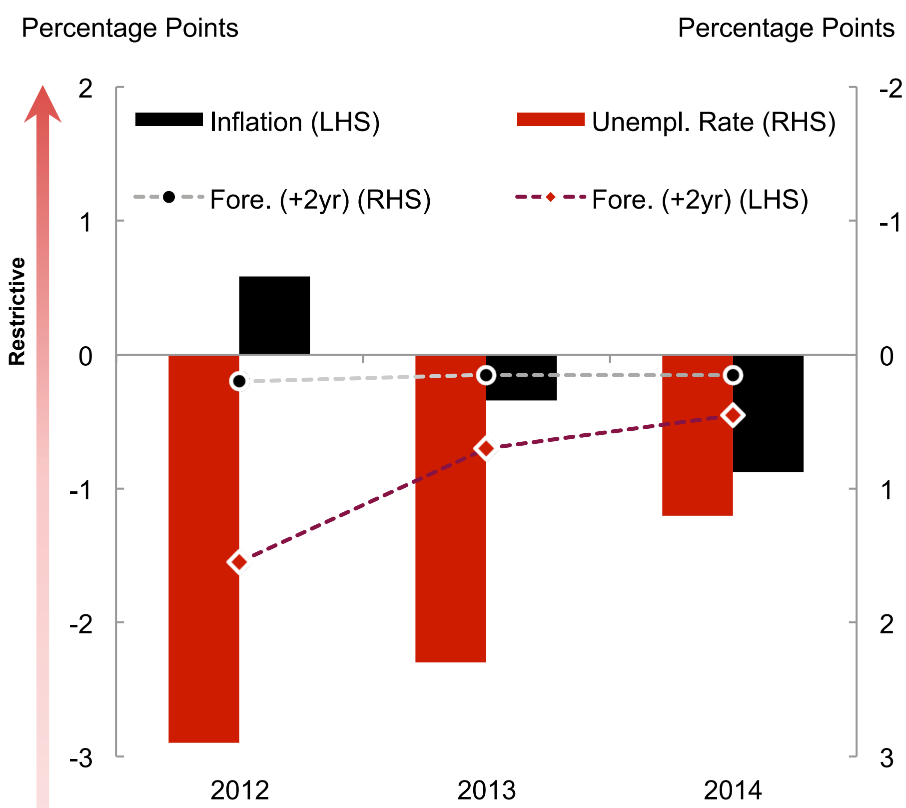


Source: National Federation of Independent Business, and Nomura

Priorities for the FOMC

- **The FOMC has focused on its employment mandate because unemployment has been so high**
- **That asymmetry in priorities should moderate**

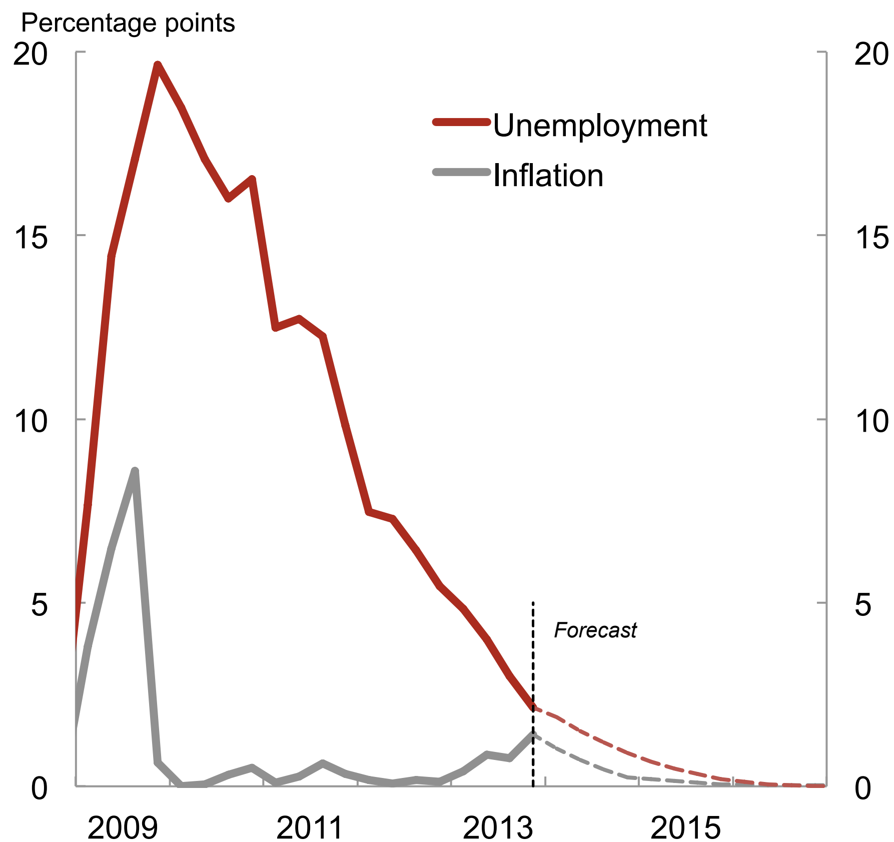
Difference between the unemployment rate and inflation and the FOMC targets



Note: Black bars show the difference between inflation the FOMC's target at the time of the first FOMC meeting of each year. The red bars show, on an inverted scale, the difference between the unemployment rate and the midpoint of the central tendency of the FOMC's long-term forecasts at the same points in time. The symbols show the where the FOMC's 8-quarter ahead forecasts for those indicators were at the same points in time.

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Nomura Economics.

"Optimal control": Squared Deviations of Inflation and the Unemployment Rate from the FOMC's Targets

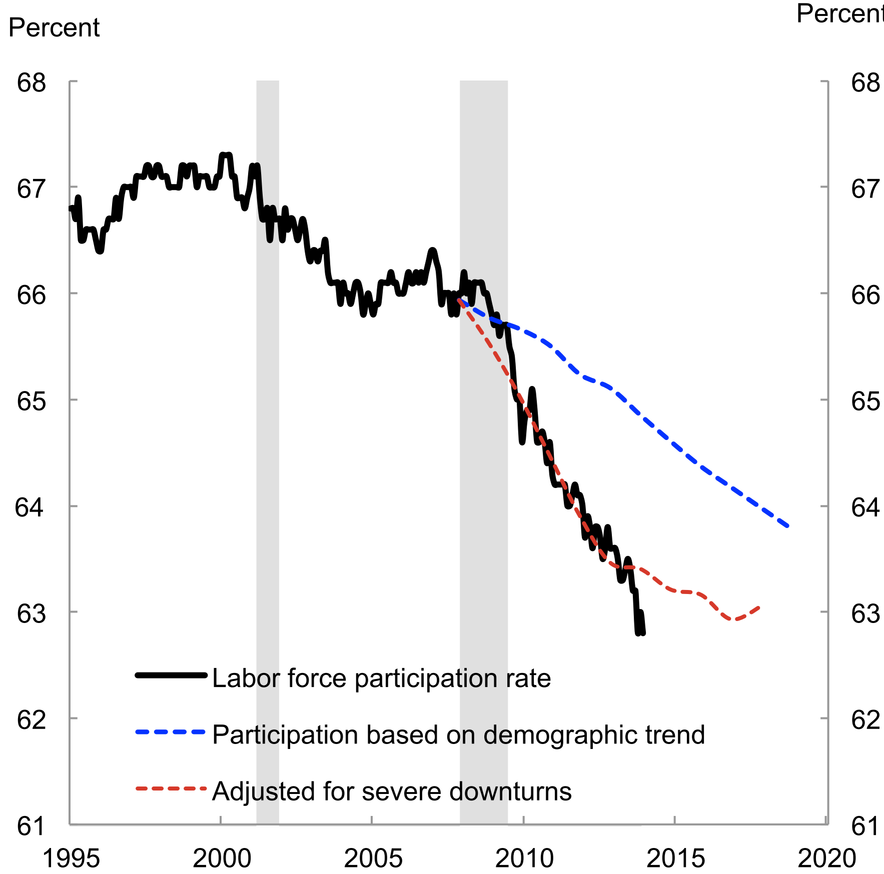


Note: Redline is the squared deviation of the unemployment rate from the midpoint of the central tendency of the FOMC's long-term forecasts for unemployment..

"Hysteresis" in labor markets (cont'd)

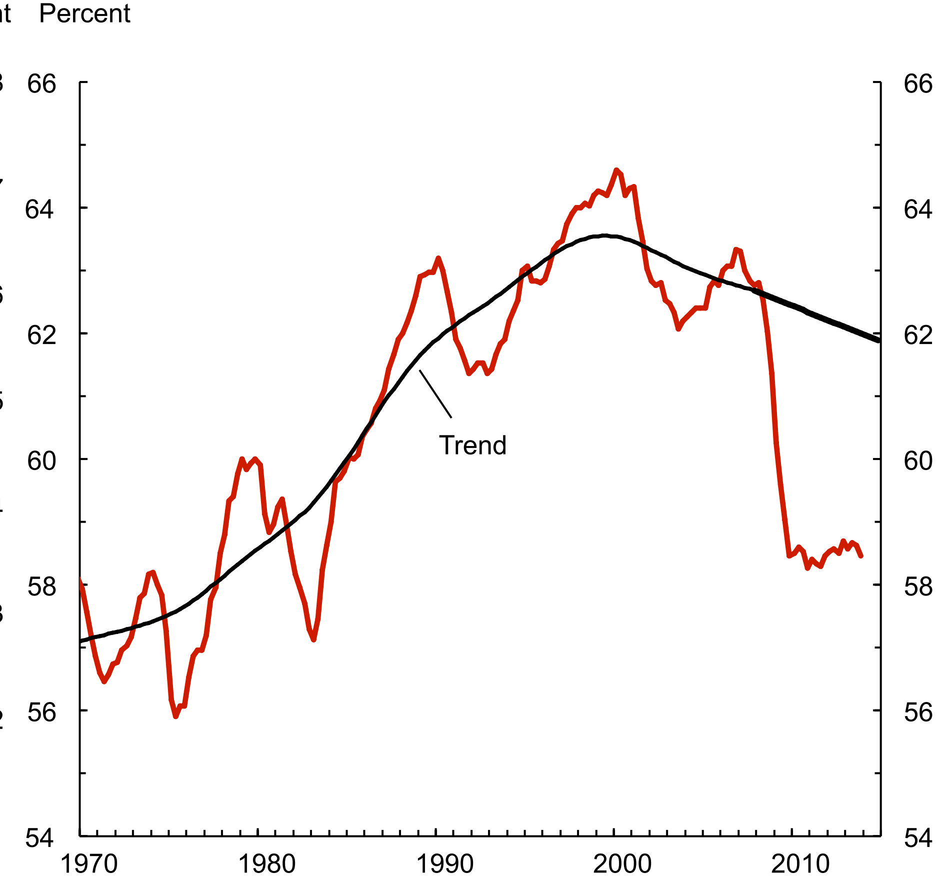
- Labor markets performance is still deteriorating.
- Is this still a justification for accommodative policy, is the damage reversible?

Actual vs projected labor force participation rate



Note: The adjustment for severe recessions comes from Duval, R., M. Eris and D. Furceri. The Effects of Downturns on Labour Force Participation: Evidence and Causes", OECD Economics Department Working Papers, No. 875, 2011.

Employment population ratio



Note: Trend estimated through 2007q1, and projected beyond that date based on the average rate of change over the period 2001-2007.

Source: Bureau of Labor Statistics, OECD and Nomura Global Economics. February 10, 2014

Short vs long-term unemployment

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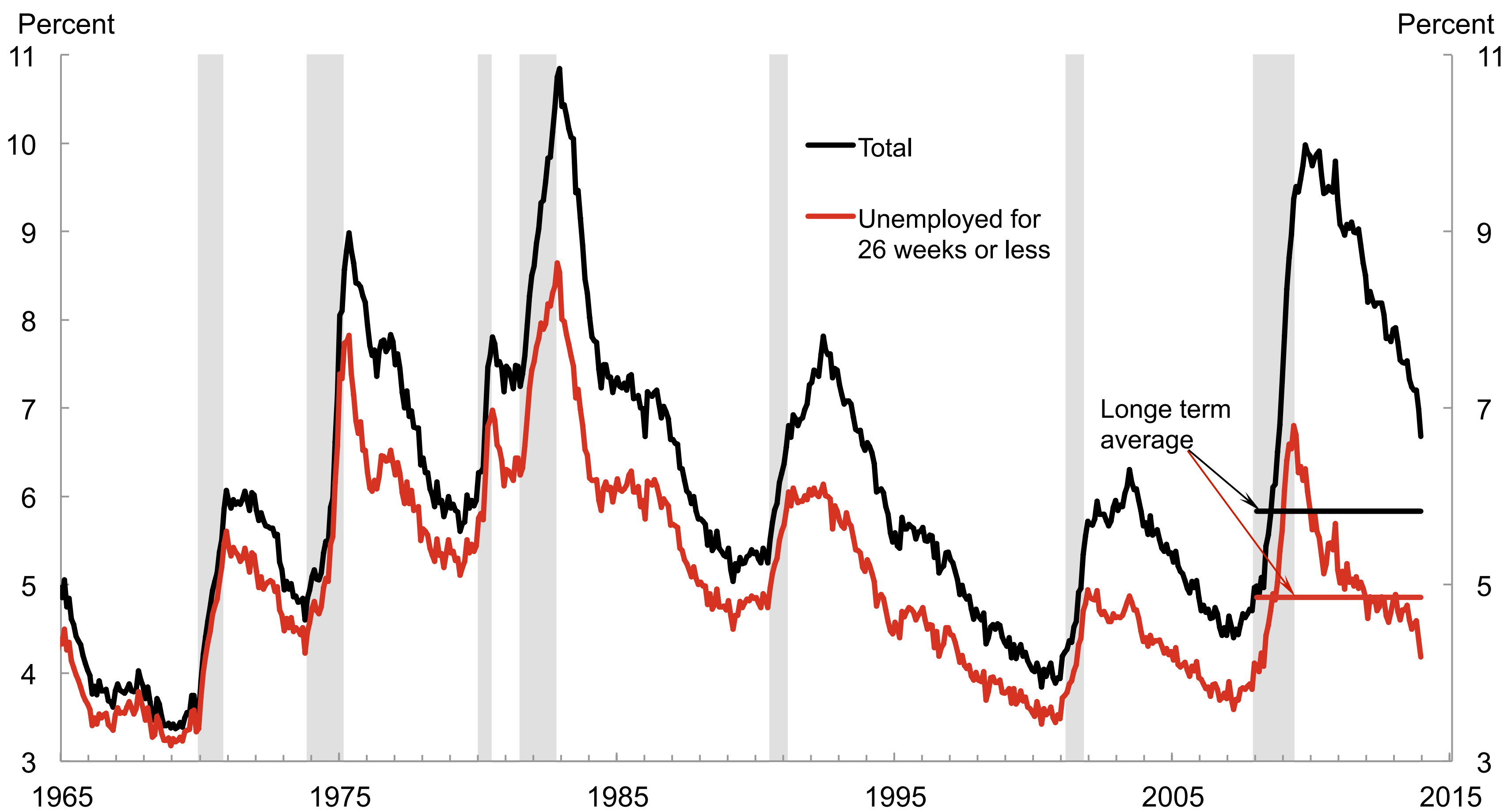
- Short-term unemployment has fallen well below its long-term average.
- The long-term unemployed have less impact on inflation.

Unemployment rate for all workers and those unemployed for 26 weeks or less.

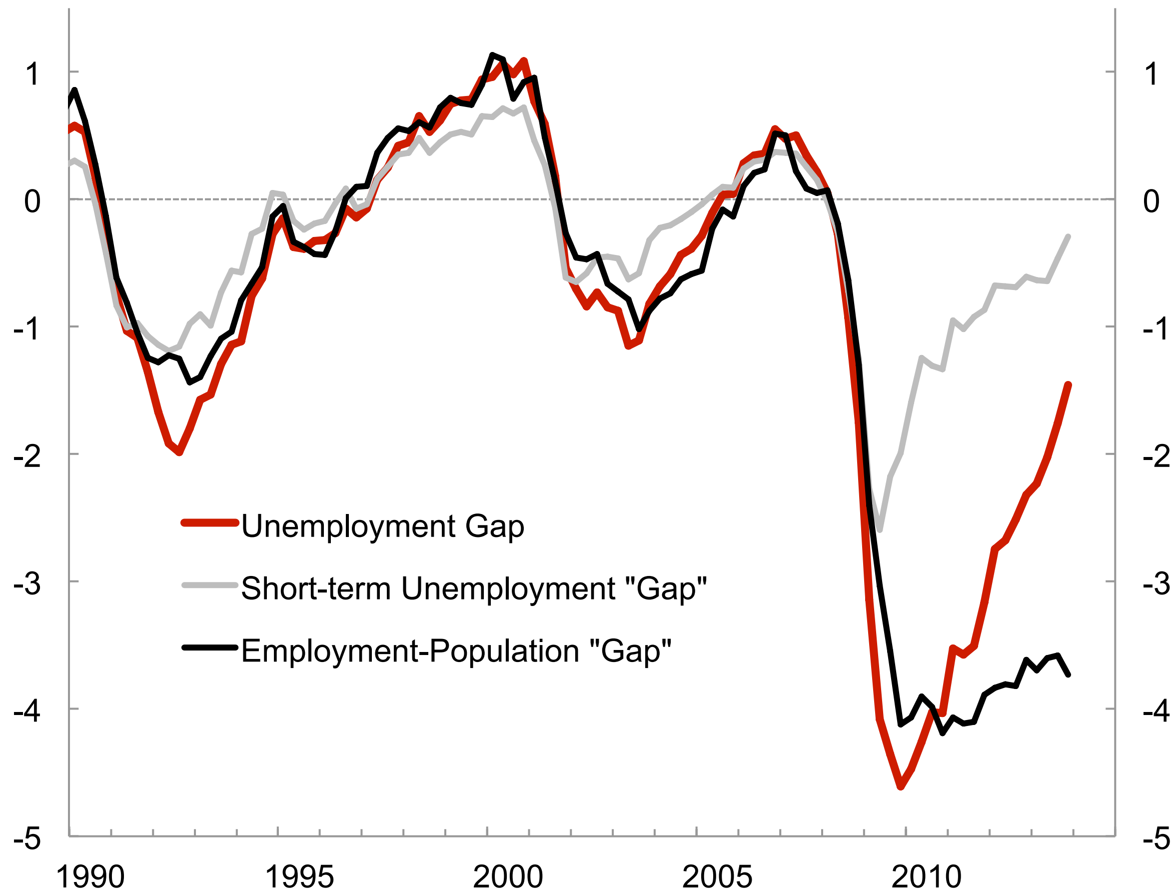


Source: Bureau of Labor Statistics, and Nomura Global Economics. © Nomura Global Economics February 10, 2014

Labor market slack and inflation

- **Broader Measures of Labor market slack are not better predictors of inflation**

Alternative measures of slack in labor markets



Source: BLS, Nomura Economics

Labor market Slack and Inflation

	Phillips Curve Coefficient	R^2
Short-term Unemployment "Gap"		
	0.24 *(3.00)*	0.401
Unemployment Gap		
	0.10 *(2.51)*	0.388
Employment-population ratio "Gap"		
	0.08 *(2.15)*	0.379

Key questions for monetary policy

1) What is the output gap, i.e., how far are we from "maximum employment?"

2) Can damage to potential output – i.e., negative "hysteresis" effects on workers and the economy – be reversed?

3) "Forecast of Commitment" – how aggressive should forward guidance be?

4) How should the FOMC respond to a "flat" Phillips curve?

5) Should concerns about systemic risk constrain monetary policy?

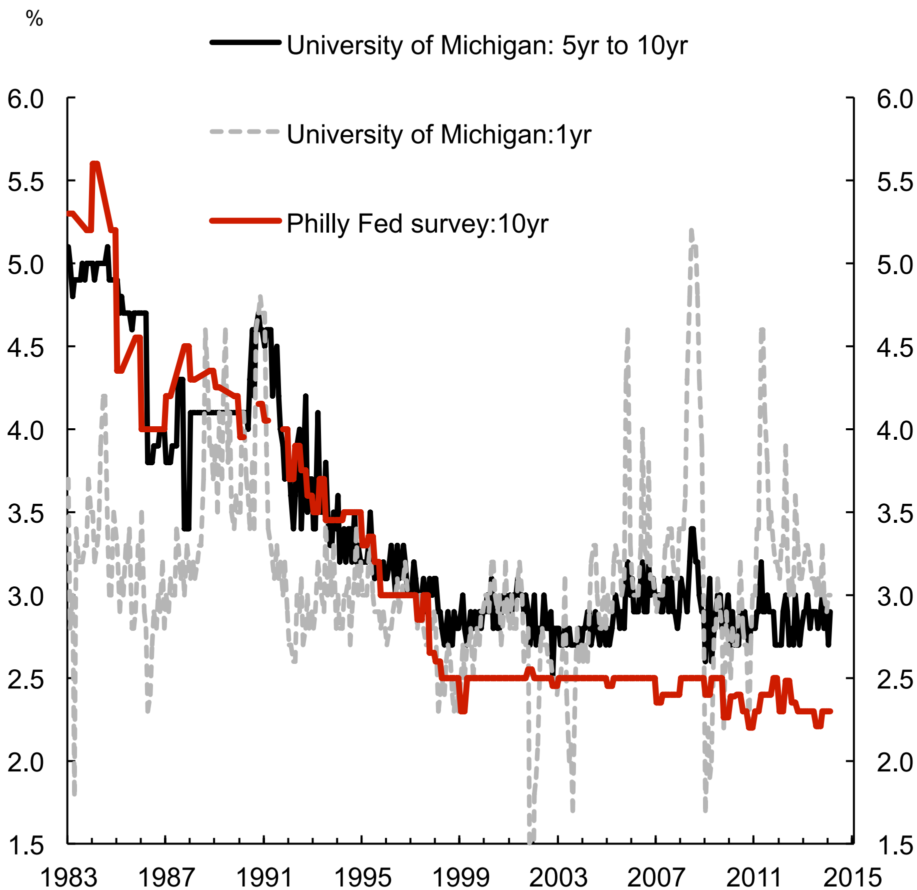
Source: Global Economics

Stable inflation expectations

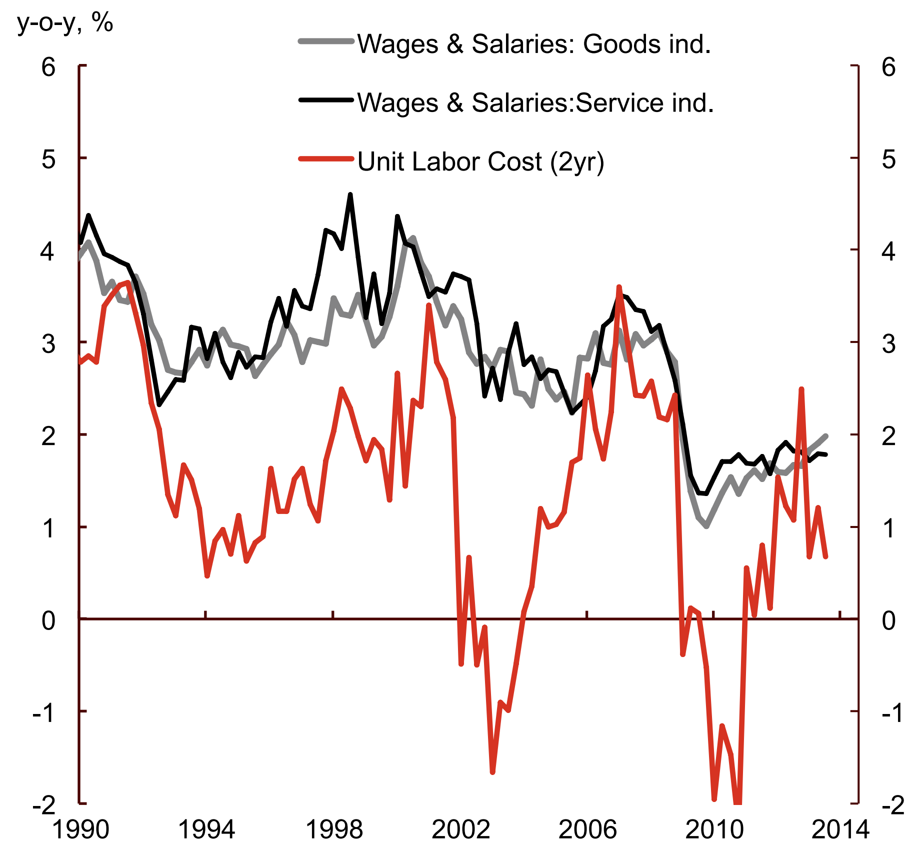
Inflation expectation measures have been stable or slightly weaker recently

Wages in the goods industries have increased at a modest pace, but have shown little acceleration in services

Alternative measures of inflation expectations



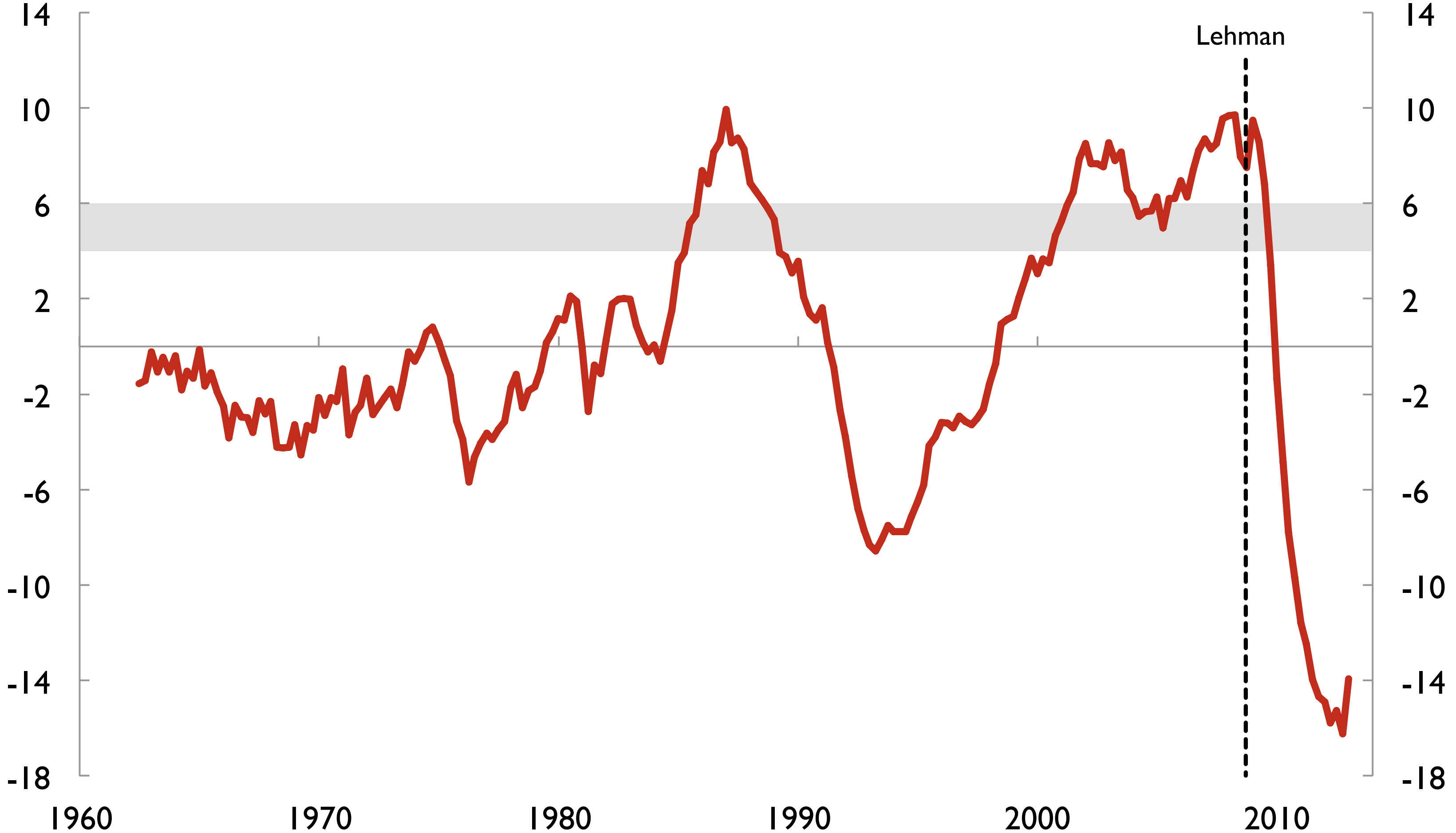
Alternative measures of Labor Cost



Source: Philly Fed, University of Michigan, Wall Street Journal, Bloomberg and Nomura Global Economics.© Nomura Global Economics February 10, 2014

Credit Trends, Recent Decades

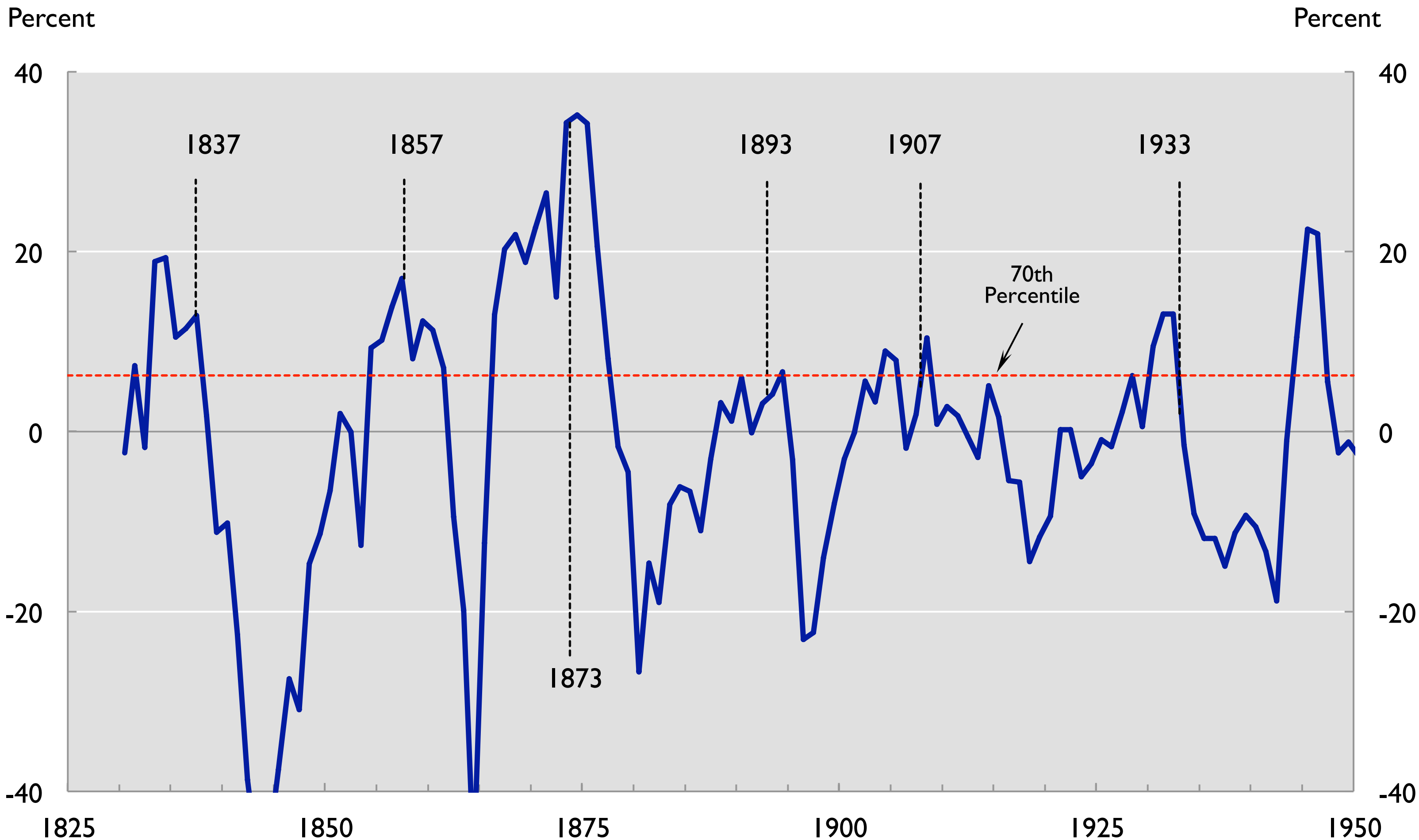
United States, deviations of the Ratio of Private Credit to GDP in the United States from Trend, Q41961-Q12011 (Percent)



Source: Federal Reserve's Flow of Funds accounts and Bureau of Economic Analysis.

Credit Trends, 19th Century

United States, deviations of the ratio of bank's loans and investments to GDP from trend, 1830-1950 (Percent)



Source: Historical Statistics of the United States.

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