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Making Sense of Thresholds, Triggers, Twists, and Timelines

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Two issues currently facing U.S. monetary policy

- Whether and how to implement a more state-contingent policy through the use of “thresholds.”
 - “State-contingent” means “dependent on economic conditions.”
- How to adjust the current stance of monetary policy given that “Operation Twist” is ending.

Thresholds

- The Committee currently uses a given date to indicate when the first increase in the policy rate will likely occur.
 - This approach has some problems.
- A possible alternative is to use “thresholds,” values for inflation and unemployment that would give an indication that the time for a rate increase may have arrived.
- However, thresholds present a new set of six distinct challenges for the FOMC.

The end of “Operation Twist”

- Operation Twist can be replaced with outright purchases of Treasury securities.
 - This is an advantage of the “state contingent” approach to the balance sheet policy adopted in September.
 - Outright purchases are likely more potent than twist operations.
 - This suggests somewhat less than one-for-one replacement if the Committee’s intent is to keep policy unchanged.
 - I interpret a one-for-one replacement of twist operations with outright purchases as more accommodating than the current policy.

Thresholds: Advantages Come With New Challenges

The pessimism problem

- The Committee currently states that the policy rate will likely remain near zero until “mid-2015.”
- This creates a “pessimism problem” for the Committee.
 - The date can be interpreted as a statement that the U.S. economy is likely to perform poorly until that time.
 - I have called this an “unwarranted pessimistic signal.”
 - Michael Woodford of Columbia University has called it potentially “counter-productive.”
 - The Committee does not intend to send such a signal.

Another problem with the date in the statement

- A second problem is more practical:
 - When the outlook for the U.S. economy changes, in principle the Committee should change the date associated with the likely first increase in the policy rate.
- However, the Committee has been reluctant to change the date unless the change in the outlook has been substantial.
- This means that markets at times have a somewhat different date in mind than in the Committee statement.

The use of thresholds may help

- The Committee may wish to eliminate the date in the statement in favor of a description of economic conditions at the time of the first rate increase.
- Then, as data arrive on U.S. economic performance, private sector expectations concerning the timing of the first rate increase would automatically adjust.
 - Vice Chair Janet Yellen has called this an “automatic stabilizer.”
- The Committee would no longer be sending the pessimistic signal, because the stated threshold conditions could be met at any time.

Some specific proposals

- The proposals that have been put forward often begin with an unemployment threshold, such as 6.5 percent, and add an inflation threshold, such as 2.5 percent.
- A threshold-style statement by the FOMC would not have a date, but would instead emphasize these economic conditions.
- The intent would be to communicate that the policy rate will remain near zero at least as long as unemployment remains high and inflation remains near target.

Implementing a threshold strategy

- Switching to a threshold strategy does not necessarily mean that policy would be easier or tighter.
- The 6.5 value for the unemployment rate is broadly consistent with mainstream analysis of the likely value of the unemployment rate at the time of the first increase in the policy rate.
 - Likewise, many expect inflation to remain low.
- The intent is to change the *approach* to policy, but keep the policy itself about as easy as it is today.

Thresholds: Six Challenging Aspects

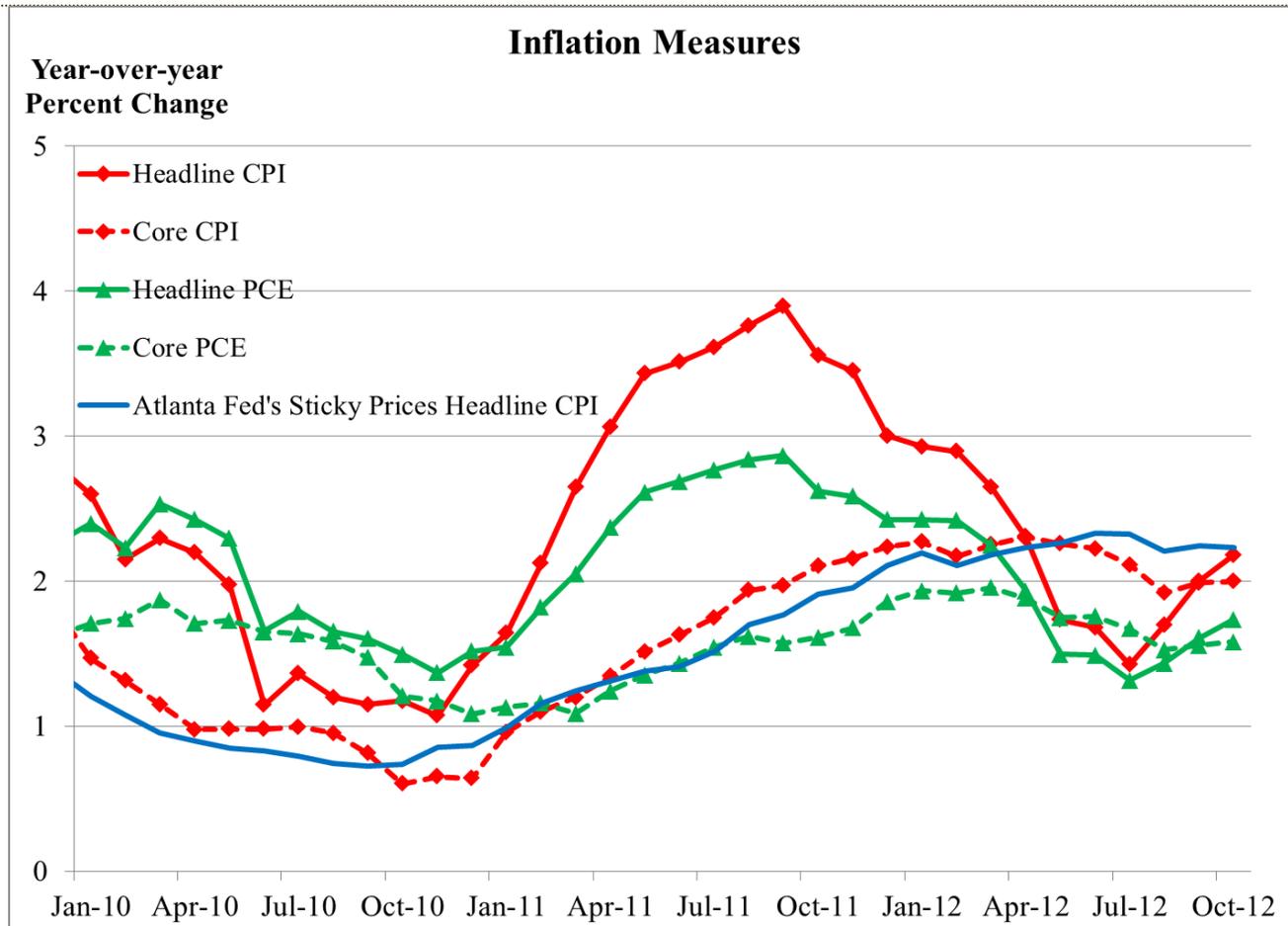
1. Not the 1960s

- Care needs to be taken that this does not represent a return to 1960s-style macroeconomics, in which many thought unemployment could be meaningfully targeted by the central bank.
- That approach to policy was badly discredited in the 1970s.
- The Committee's January 2012 statement makes it clear that the FOMC cannot meaningfully target unemployment.

2. Maintaining a balanced approach to policy

- Many proposals suggest considering the *forecast* for inflation but the *actual value* of unemployment.
- In order to maintain a balanced approach to policy, the two variables should be treated symmetrically.
- My preference is for a statement in terms of actual values for both inflation and unemployment.

Inflation measures



3. The Committee considers all aspects of the data

- Care should be taken that the Committee does not leave the impression that only these two variables matter for monetary policy.
- That would greatly oversimplify any reasonable judgment concerning the state of the U.S. economy.
- There may be reasons other than high inflation that could lead to an increase in the policy rate.
 - Example: low rates fuel asset price bubbles.

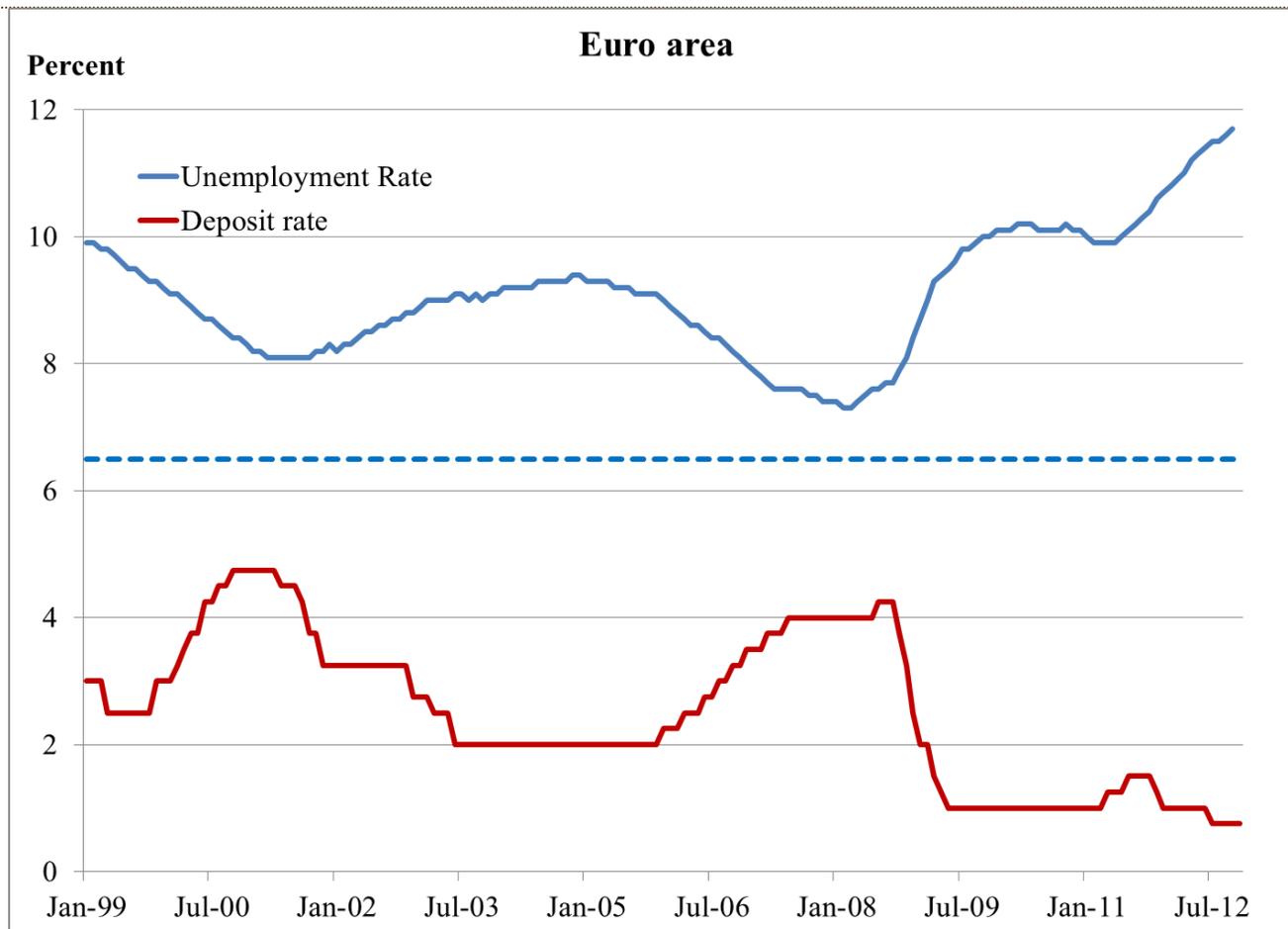
4. The health of the labor market is multi-faceted

- The Committee needs to stress that the unemployment rate is only one aspect of the health of the labor market.
 - The Committee weighs labor market outcomes from a broader perspective.
 - A key metric is the payroll employment reading each month.
 - The labor force participation rate has been a very important factor during the last several years.
 - Measures of hours worked help us to understand the full-time versus part-time aspects of labor market outcomes.
 - Other measures, including turnover data, have also been important.

5. Unemployment can remain high

- The Committee needs to emphasize that unemployment can remain elevated for reasons unrelated to monetary policy.
- In particular, elevated European unemployment over the last several decades provides a stark warning that this variable does not always behave as one might expect.
- An unemployment threshold of 6.5 percent would never have been breached in the Euro zone over the last twenty years.
 - Despite this, the ECB did raise the policy rate at times during this period and did keep the Euro-area inflation rate near two percent.

Euro-area unemployment and policy rates



6. Thresholds will be viewed as triggers

- The Committee may need to recognize that thresholds will likely be treated as “triggers for action” in financial markets.
- In essence, the effect of a threshold announcement is to draw a line in the sand.
 - Crossing the threshold means something significant has occurred.
 - Even if policy action is not required right at that moment, the probability of action is increased.
- Markets will react to the probability of policy action.

The End of Operation Twist

Operation Twist ends

- “Operation Twist” has been continuing during the second half of 2011 and all of 2012.
- The program includes sales of shorter-term Treasury securities in conjunction with purchases of longer-term Treasury securities.
- Outright purchases of longer-dated Treasuries with newly created reserves eliminates the sale of short-term securities and so may be viewed as somewhat more stimulative.

Replace with outright purchases?

- Analysis of the effects of the twist program in comparison to the QE programs yields mixed results.
 - Still, on balance I think it is reasonable to think that an outright purchase program has more impact on inflation and inflation expectations than a twist program.
- Replacing the expiring twist program one-for-one with outright purchases of longer-dated Treasuries is likely a more accommodating policy.
 - If the goal is to keep policy on its present course, the replacement rate should be less than one-for-one.

Conclusions

Summary

- A threshold approach to the policy rate could help the Committee avoid the “pessimistic signal” problem.
- However, a threshold approach creates at least six distinct challenges for the Committee.
- Replacing the expiring twist program one-for-one with outright purchases of longer-dated Treasuries is likely more dovish than current policy.



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