The Fed on Pause

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Any opinions expressed here are my own and do not necessarily reflect those of others on the Federal Open Market Committee.

This talk

- The Fed on pause.
- Risks to the pause policy.
- Fed communications: Time for a more fulsome report?

The Fed on Pause

The Fed has been easing aggressively since 2008

- The policy rate was lowered in early 2008, hit near-zero in late 2008, and remains there today.
- The FOMC purchased agency MBS in 2009.
- The FOMC began QE2 in 2010 as deflation loomed.
- In 2011, the FOMC began a version of "Operation Twist" which continues today.
- Also in 2011, the Committee began to give calendar date guidance regarding the first increase in the policy rate, currently set at "late 2014."

Easy policy remains in effect

- These Fed actions remain impactful today.
- The policy rate remains near-zero.
- The large Fed balance sheet remains in place.
- "Operation Twist" is still ongoing and will alter the balance sheet composition for some time to come.
- The calendar date language is still in effect.

U.S. macro data have been relatively strong

- Meanwhile, the U.S. macroeconomic data have been stronger than expected as of last autumn.
- The U.S. avoided the "recession scare" of last August-September, instead growing at a moderate rate.
- Labor market data have been moderately strong, and unemployment has fallen faster than expected.
- Inflation has moved up over the last 18 months.

The Fed on pause

- The ultra-easy monetary policy …
- … much of which is still impacting the U.S. economy …
- … along with better-than-expected data over the last 9 months …
- … combine to put the FOMC on hold, or pause, in its aggressive easing campaign.

The Risks

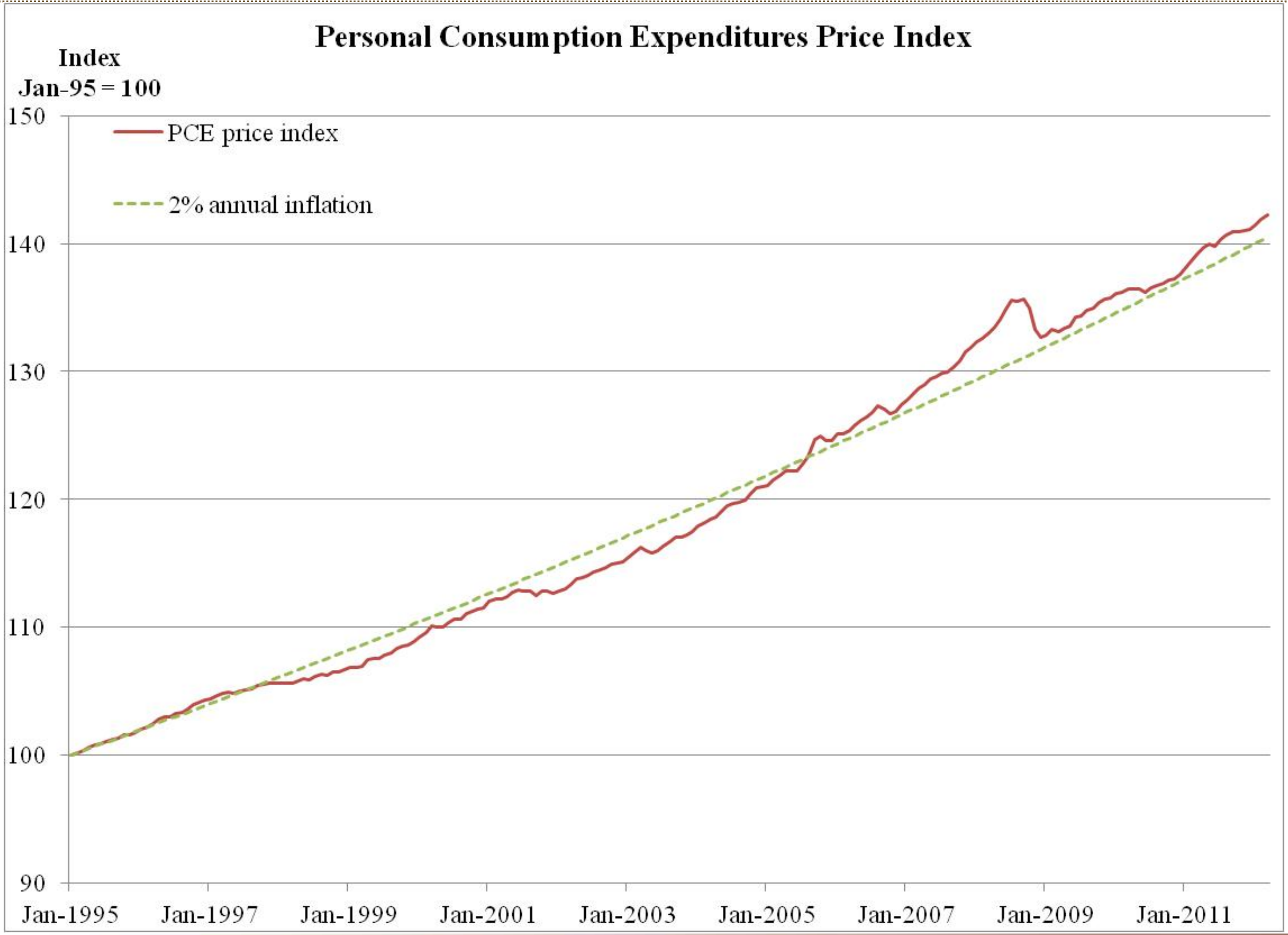
The main risk

- The main risk is that the Committee will, as it has in the past, overcommit to the ultra-easy policy.
- The policy has been appropriate so far, but could reignite a 1970s-type experience globally if pursued too aggressively.
- The 1970s era included 4 recessions in 13 years, double-digit inflation, and double-digit unemployment.
- The lesson was clear: "Do not let the inflation genie out of the bottle."

Other risks

- The Committee has done too little?
  - This seems unlikely given the litany of major policy actions listed in earlier slides.
  - If anything, the Committee may be trying to do too much with monetary policy, risking monetary instability for the U.S. and the global economy.
- The U.S. economy may encounter further negative shocks?
  - It is possible, but the Committee can respond as appropriate to a significant deterioration relative to the current forecast.
- The FOMC has allowed the price level to fall off the appropriate path?

Price level path seems appropriate



Source: Bureau of Economic Analysis and author's calculations. Last observation: March 2012.

Labor market policies

- The U.S. has about 12.5m unemployed people, against 142m employed and 88.4m out of the labor force.*
- Labor market policies such as unemployment insurance and worker retraining have direct effects on the unemployed.
- Monetary policy is a blunt instrument which affects the decision making of everyone in the economy.
- It may be better to focus on labor market policies to directly address unemployment instead of taking further risks with monetary policy.

** Source: Bureau of Labor Statistics. April 2012 data.*

Additional distortions

- The near-zero rate policy has been in place for more than three years, and is projected for several more.
- This length of time is far beyond the typical recession/recovery discussion in the academic literature.
- The near-zero rates cause other distortions in the economy, including punishing savers.

Fed Communications

The Fed has become more transparent

- The FOMC has increased the degree of transparency surrounding monetary policy in a variety of ways since the 1990s.
- In January 2012, the Committee began releasing forecasts of the FOMC participants.
- The forecasts include a future path for the policy rate.
- The reception for this aspect of increased transparency has been mixed.

Possible improvements to communications

- The current communication strategy operates with only a few variables, while the economy is described by many variables.
- The FOMC could instead publish a quarterly document akin to the Bank of England's "Inflation Report."
- This could potentially provide a more fulsome discussion of the outlook for the U.S. economy and for policy than is currently provided.

A broader discussion of the U.S. outlook

- A report of this type could potentially lay down a benchmark "Fed view" on the key issues facing the U.S. economy.
- Release of the report could be coordinated with the quarterly press briefings conducted by Chairman Bernanke.
- FOMC participants could point out where their views differ from the benchmark.
- Many other central banks proceed in this manner.

Conclusions

Summary

- The Fed is on pause because:
  - The existing stance of policy is already ultra-easy.
  - The economy has outperformed expectations since last fall.
- The main risk lies in potentially overcommitting to the ultra-easy monetary policy, reigniting the global inflation debacle of the 1970s.
- It may be possible to improve FOMC communications further by producing a quarterly report similar to those produced by other central banks.

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Federal Reserve Economic Data (FRED)
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