An Update on the Tapering Debate

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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.

Introduction

This talk

- In June, the FOMC authorized Chairman Bernanke to present a roadmap for a possible reduction in the pace of asset purchases by the Fed.
  - This is often referred to as "tapering" asset purchases.
- The Chairman emphasized an approach that depends on economic conditions, but that could begin in the fall of this year.
- What types of arguments might be made for or against tapering?
- In this talk, I will provide some of my own views on the debate without pre-judging its conclusion.

Recent Developments

The components of current policy

- Current U.S. monetary policy has three components: The policy rate, forward guidance, and asset purchases.
- The policy rate itself has been near zero since December 2008 and remains there today.
- There are two "unconventional" aspects to policy:
  - Forward guidance is a promise to keep the policy rate near zero at least until unemployment falls below 6.5 percent or inflation rises above 2.5 percent.
  - Asset purchases of Treasuries and MBS are continuing at $85 billion per month until there is substantial improvement in the labor market.

A separation principle

- The Chairman has emphasized that any decision on the asset purchase program is conceptually separate from any decision concerning the policy rate.

- In particular, a decision to reduce the pace of asset purchases does not change the nature of the Committee's commitment to keep the policy rate near zero.

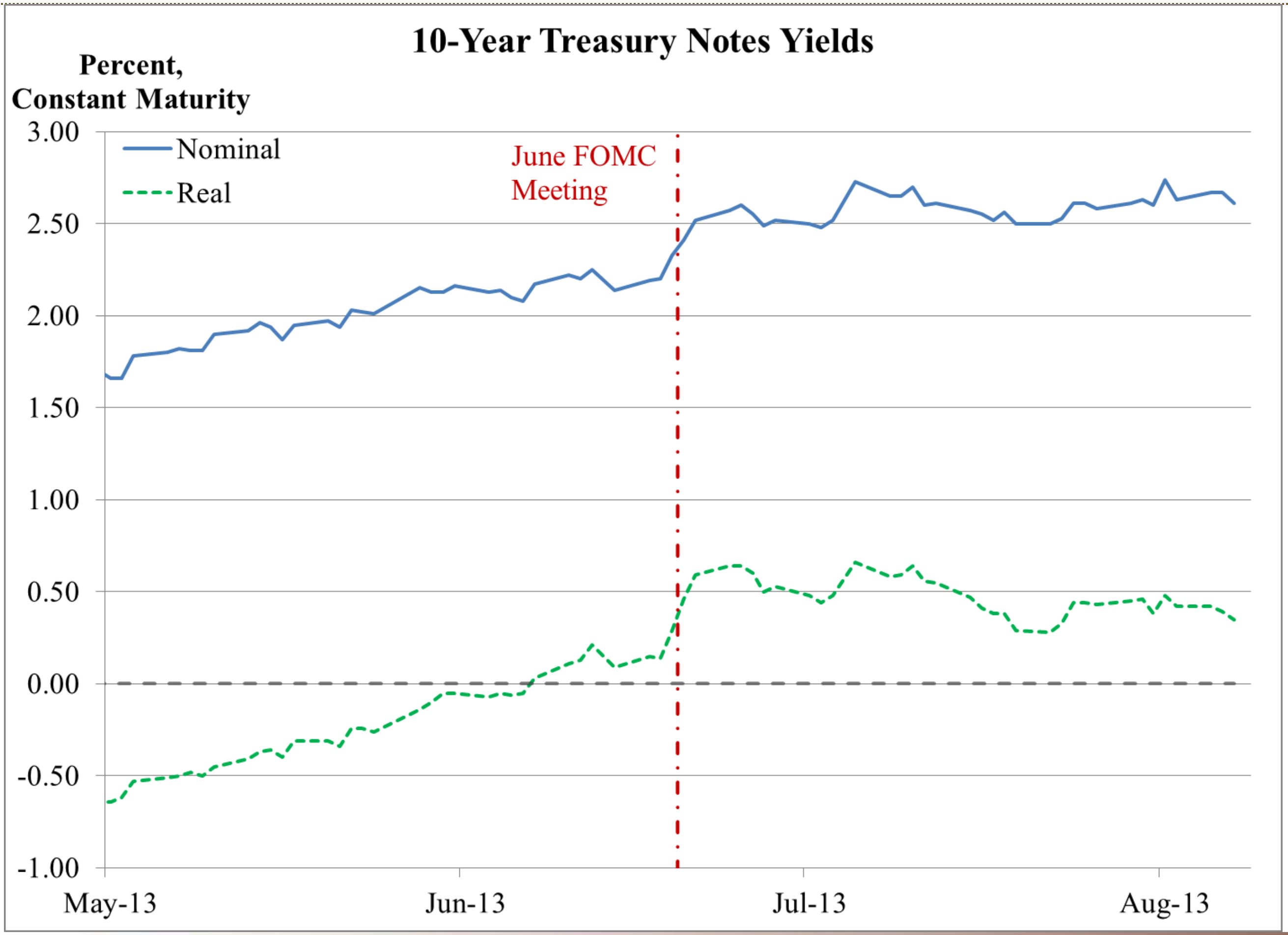
The June FOMC meeting

- At the June press conference, Chairman Bernanke discussed possible plans for reducing the pace of asset purchases.
- The financial market reaction was substantial, even though the Committee did not actually change any policy settings at that point or at its recently-concluded July meeting.
- The next few slides characterize some of the market reaction.

Interest rates rose …

- Both nominal and real interest rates have increased since the beginning of May ….

Nominal and real yields

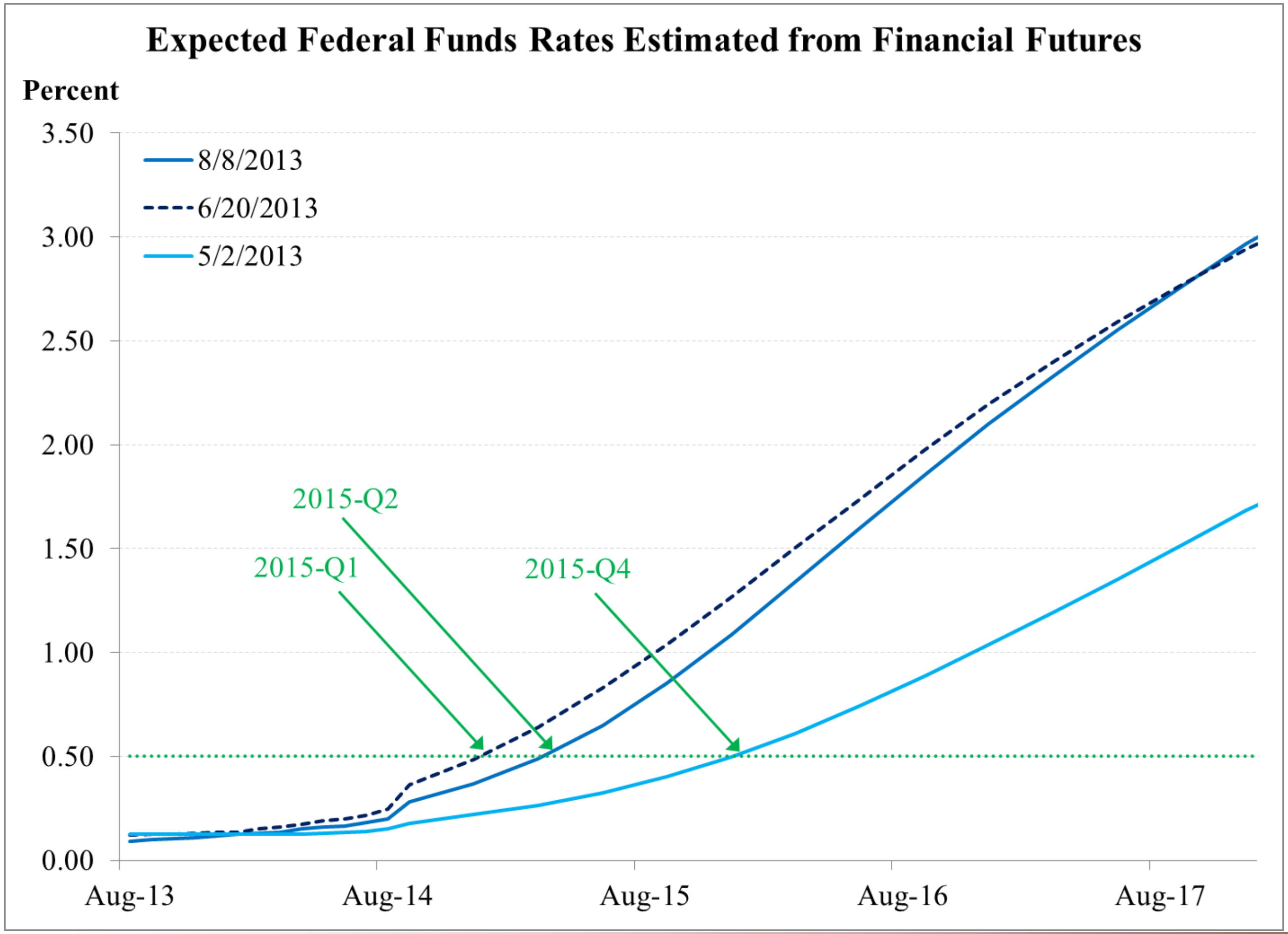


Source: Federal Reserve Board. Last observation: August 7, 2013.

The expected policy rate rose …

- The expected path of the policy rate increased, meaning that the date of expected liftoff is earlier than it was in May.
- This suggests that any tapering decision is difficult to separate from Committee promises on the expected path of the policy rate.

The expected policy rate path

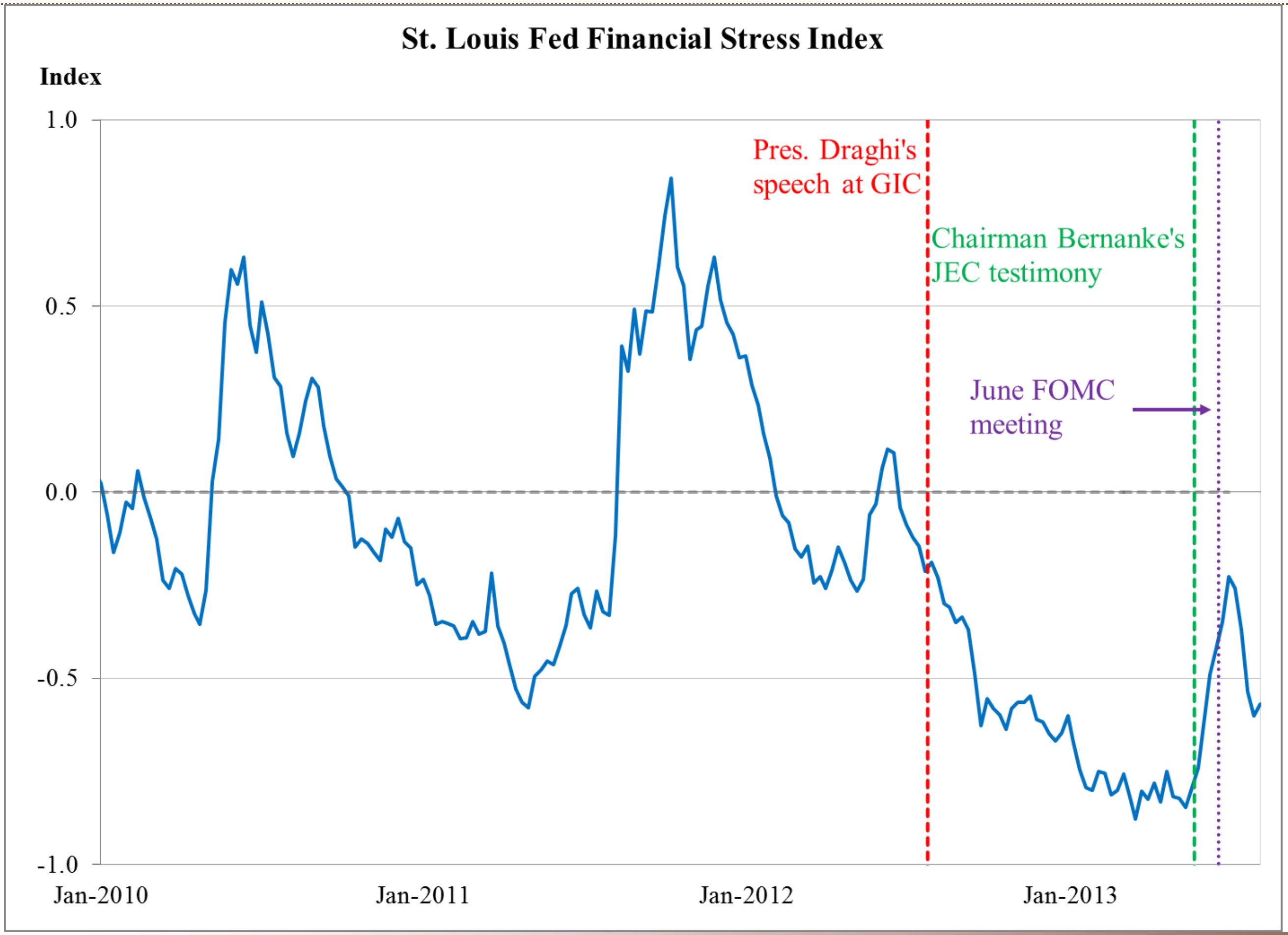


Source: author's calculations. Last observation: August 8, 2013.

Financial stress measures increased …

- The St. Louis Fed Financial Stress Index increased, but from relatively low levels ….

St. Louis Fed Financial Stress Index



Source: Federal Reserve Bank of St. Louis. Last observation: week of August 2, 2013.

Tapering: Pros and cons

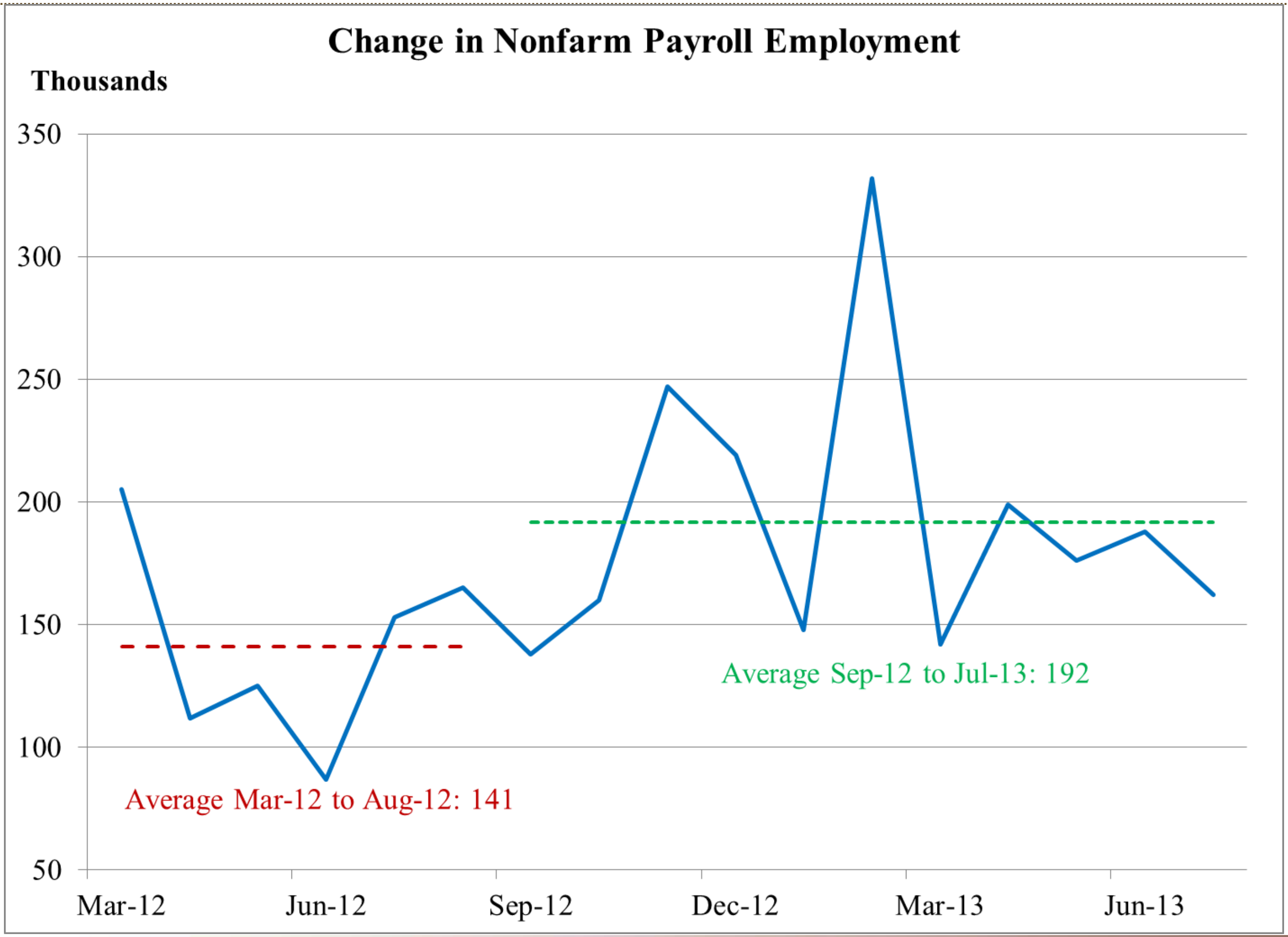
- In this talk, I will provide some of my views on how four areas of macroeconomic performance might be interpreted with respect to tapering:
  - Labor market performance
  - Growth
  - The large balance sheet of the Fed
  - Inflation
- I will conclude by suggesting that the Committee still needs to see more data on macroeconomic performance for the second half of 2013 before making a judgment on this matter.

Labor Market Performance

Labor market performance

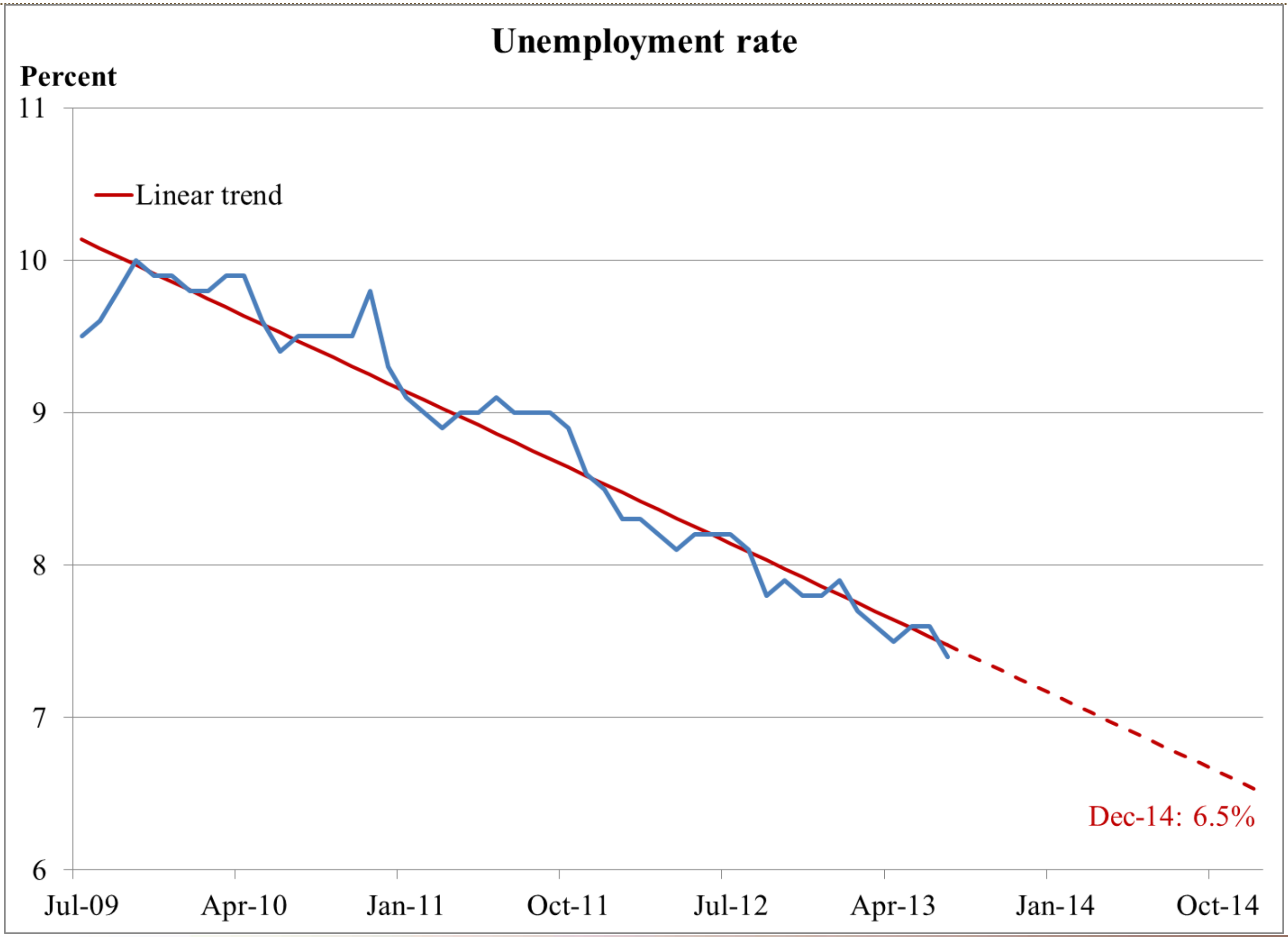
- When the Committee adopted QE3 last September, the stated criterion for the program was substantial improvement in labor market performance.
- By some key measures, labor markets have indeed improved since last September.
  - Unemployment is lower.
  - Payroll employment growth has generally been strong.
- But other labor market measures have not improved.

Nonfarm payroll employment



Source: Bureau of Labor Statistics. Last observation: July 2013.

Unemployment rate

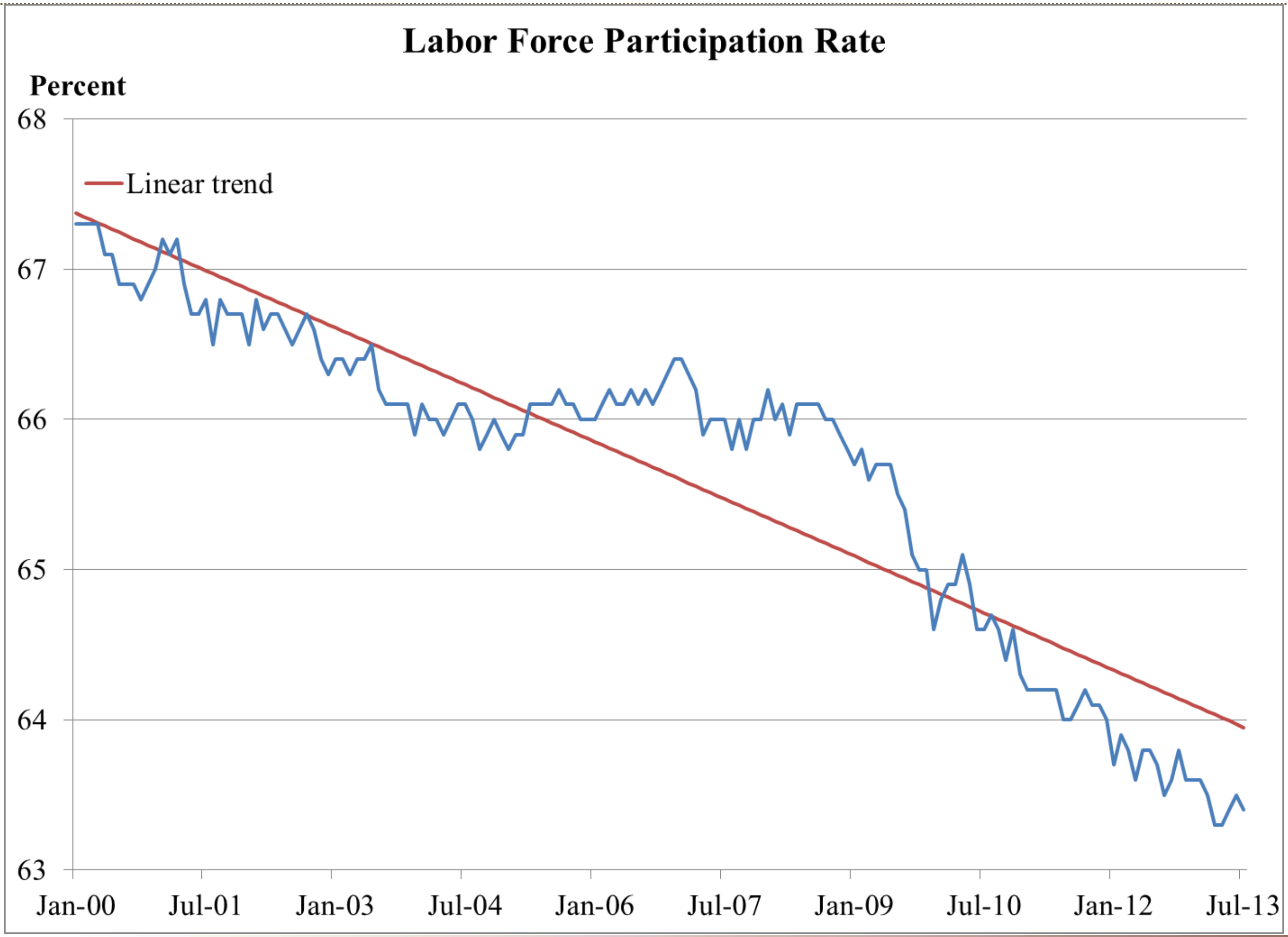


Source: Bureau of Labor Statistics. Last observation: July 2013.

Alternative labor market measures

- However, according to some alternative measures, labor market performance remains weak:
  - Labor force participation remains on a downward trend.
  - The employment-to-population ratio remains low.
  - The growth in hours worked is slower than it was as of last September.

Labor force participation rate

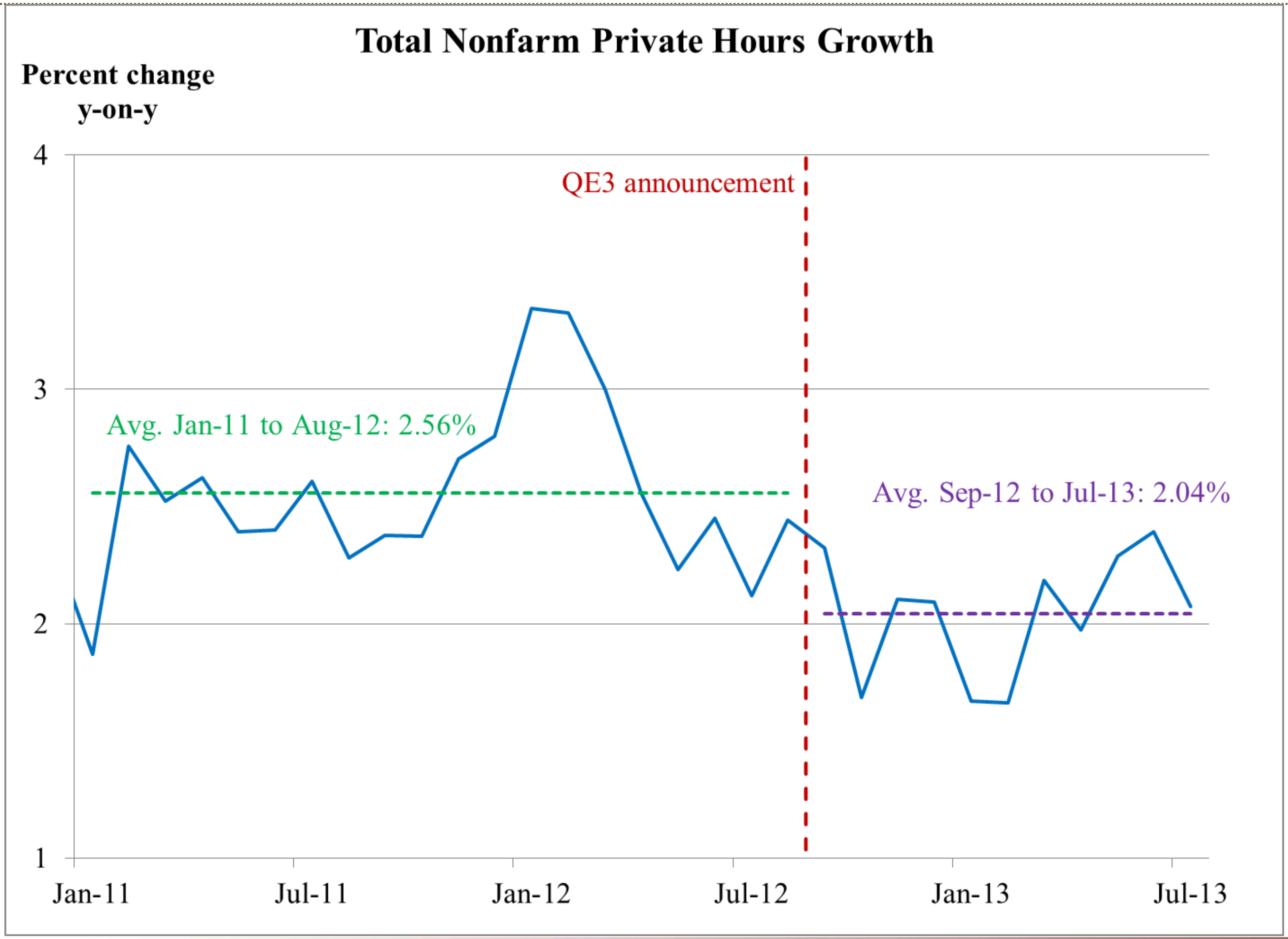


Source: Bureau of Labor Statistics. Last observation: July 2013.

Employment-population ratio

Source: Bureau of Labor Statistics. Last observation: July 2013.

Growth in total nonfarm private hours



Source: Bureau of Labor Statistics. Last observation: July 2013.

A key labor market issue for the tapering debate

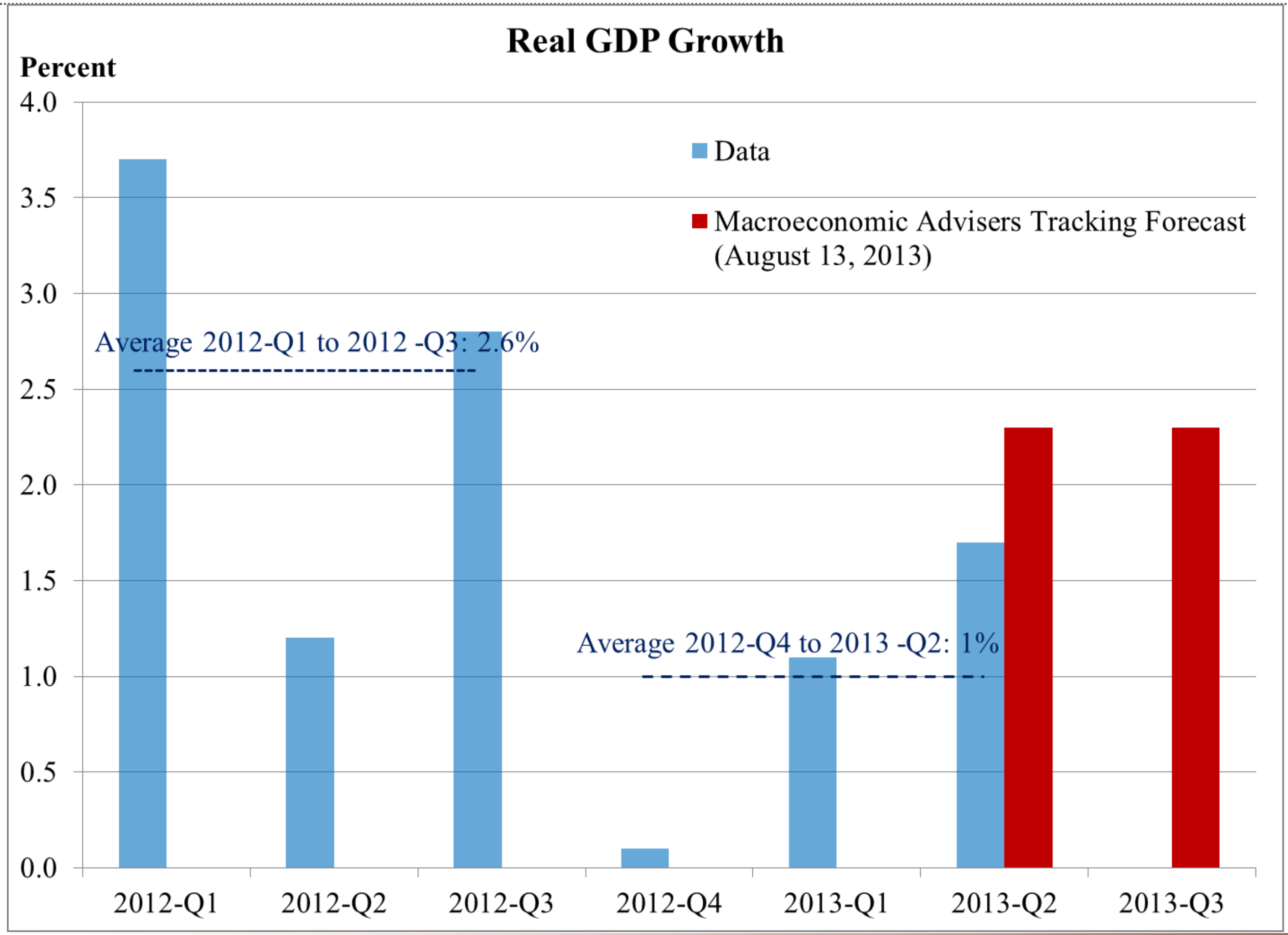
- Should the Committee focus attention primarily on nonfarm payrolls and unemployment, or should the Committee consider a wider range of labor market indicators?
  - If the former, then labor markets have clearly improved since September 2012.
  - If the latter, then labor markets may be judged to remain weak, but the criterion for labor market improvement would be considerably muddied.

Growth in Real GDP

Growth in real GDP

- A standard variable for the assessment of U.S. macroeconomic performance is growth in real GDP.
- Normally, the Committee would not remove accommodation if real GDP growth was viewed as weak.
- Recent real GDP growth has been weak.
  - But, the most recent data suggests a stronger Q2 than previously expected.

Real GDP growth



Source: Bureau of Economic Analysis and Macroeconomic Advisers. Last observation: 2013-Q2.

Growth in real GDP

- Even if current GDP growth is viewed as quite slow, future growth may be better.
- We can call this "optimism."
- The Committee may wish to remove accommodation if future growth is expected to be strong.

The case for optimism

- The case for an optimistic view of future U.S. macroeconomic performance is simple.
- In a nutshell, many, but not all, of the factors slowing the U.S. economy down are waning.
  - Real estate markets are improving, equity markets have rallied, the European sovereign debt crisis remains subdued for now, U.S. fiscal brinksmanship has been less of a problem, and household deleveraging is further along.

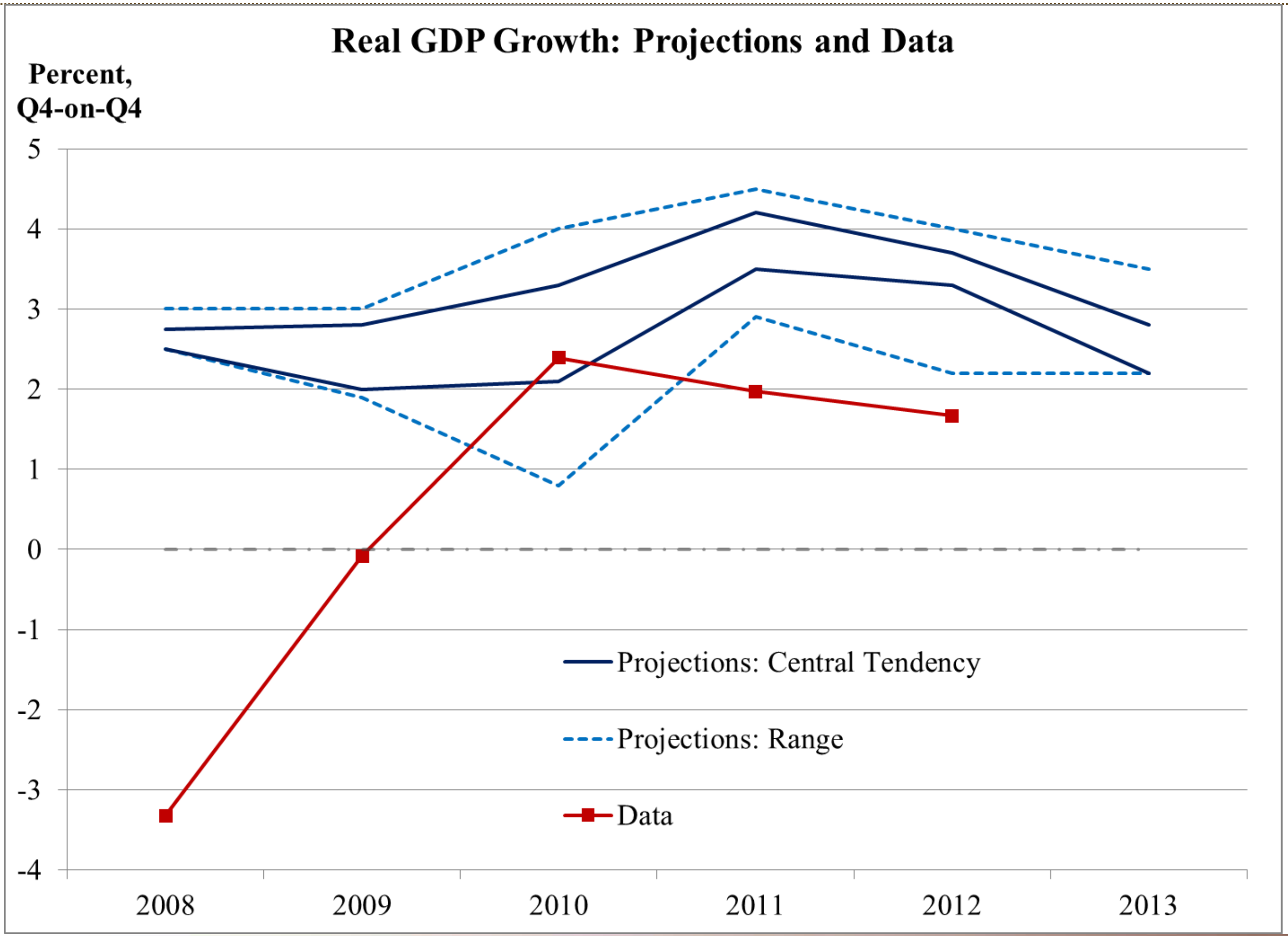
The problem with optimism

- I have been optimistic in my own forecasts for the U.S. economy over the last several years.
- In part, this is because empirical models suggest that, with the current configuration of data and policy settings, rapid growth lies just ahead.
- I have tempered these forecasts with an explicit recognition that economies tend to grow more slowly following a financial crisis.
- Still, I have generally been too optimistic.
- Given this experience, I think caution is warranted in taking policy action based on forecasts alone.

FOMC forecasts

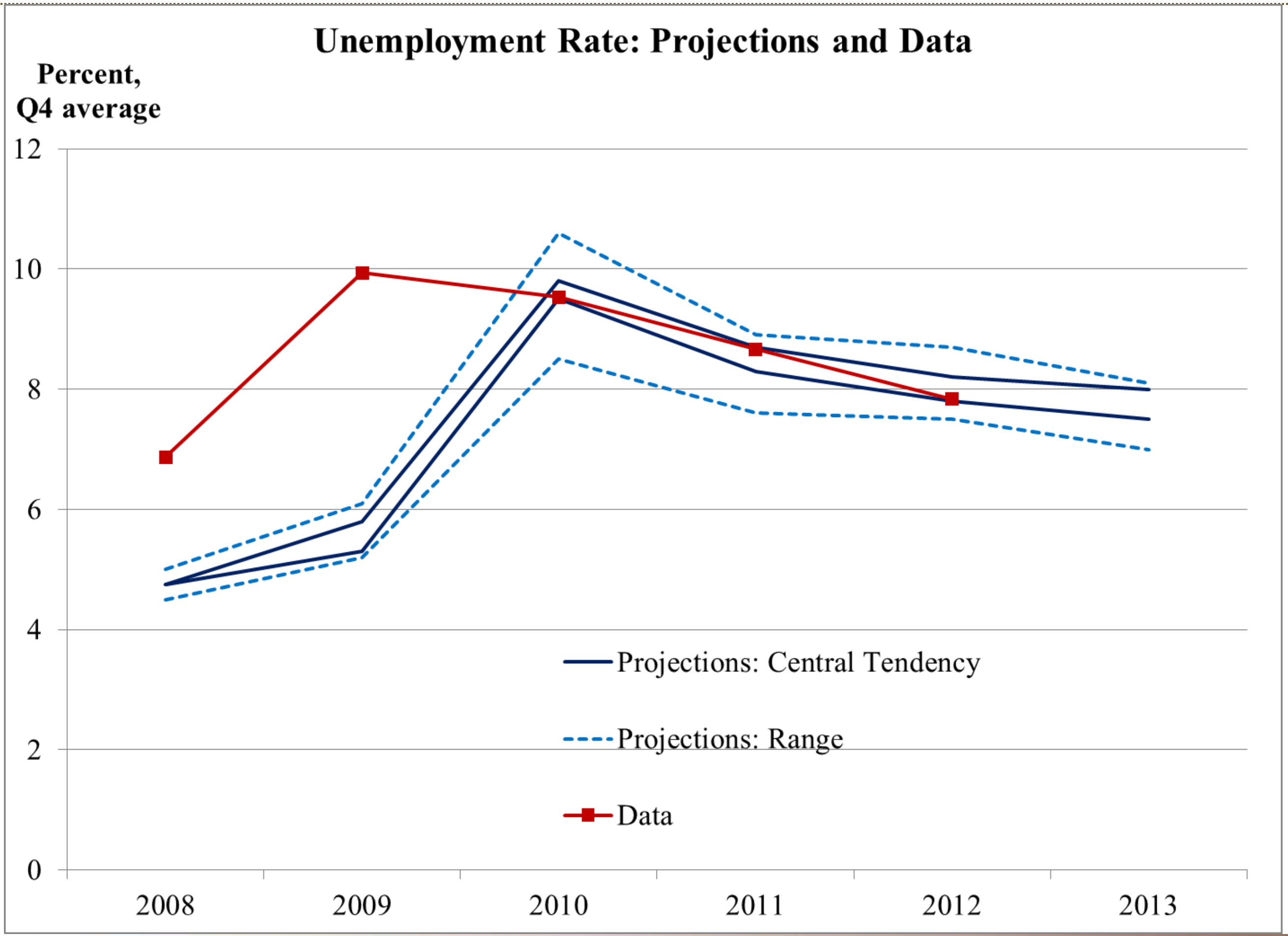
- It is not just me: FOMC forecasts (and many private sector forecasts as well) have tended to be too optimistic over the last several years.
- The following charts show the mid-year forecast of the next year's outcome for key macroeconomic variables.
- The real GDP forecasts, in particular, have generally been too high.

Forecast errors: real GDP growth



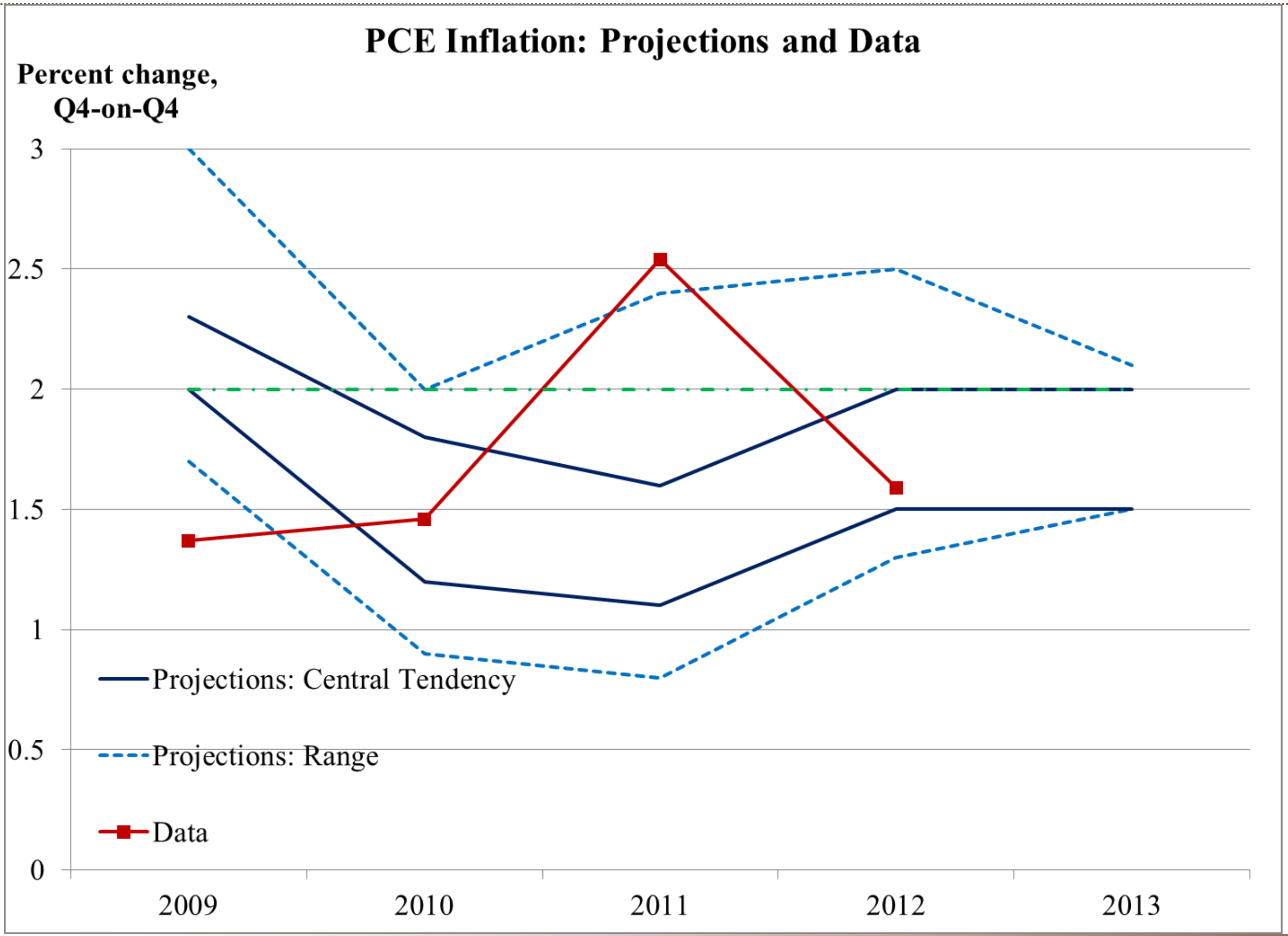
Source: Federal Reserve Board. Economic projections of Federal Reserve Governors and Reserve Bank presidents in the Monetary Policy Report to the Congress from the previous July.

Forecast errors: unemployment



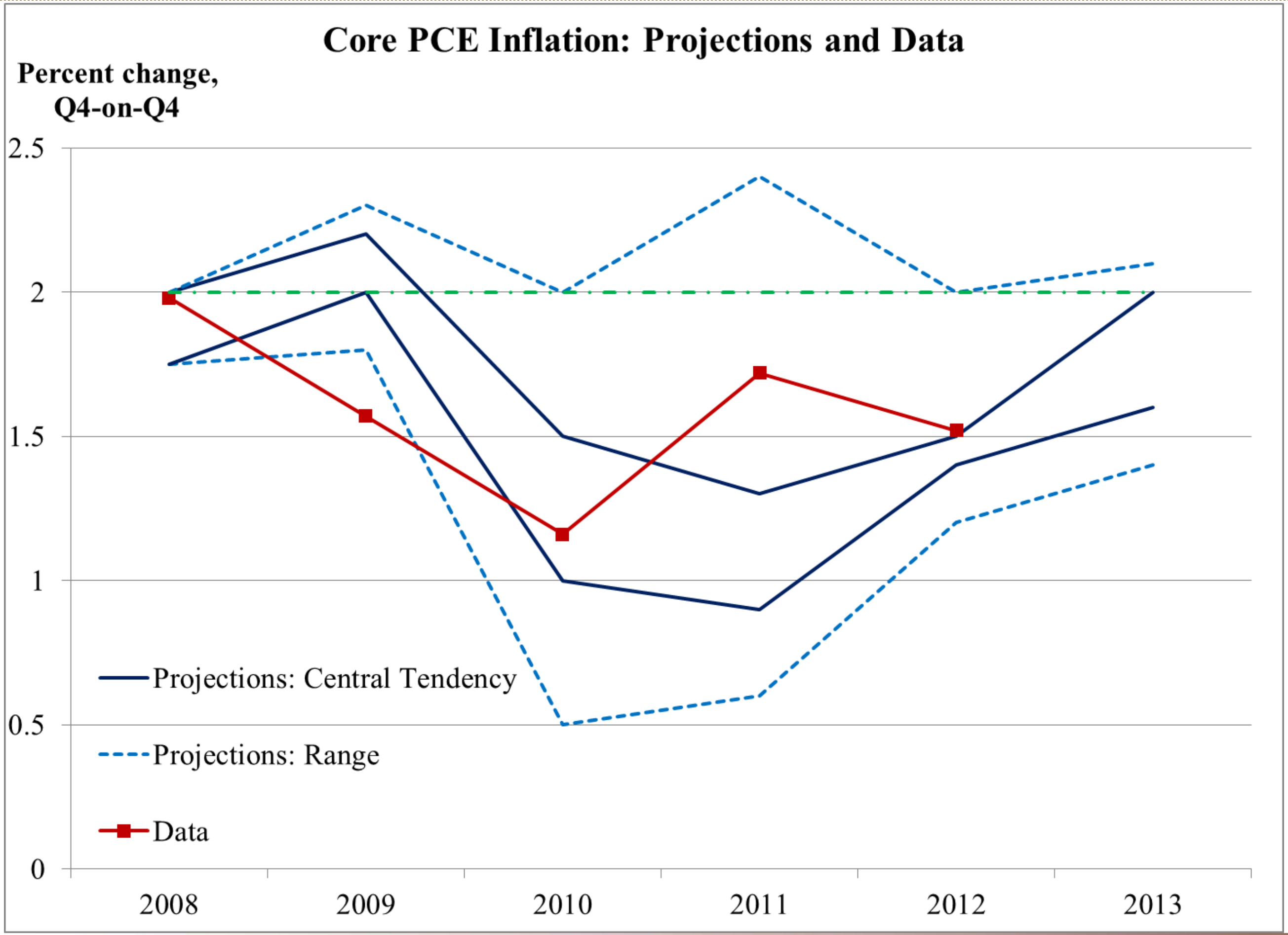
Source: Federal Reserve Board. Economic projections of Federal Reserve Governors and Reserve Bank presidents in the Monetary Policy Report to the Congress from the previous July.

Forecast errors: PCE inflation



Source: Federal Reserve Board. Economic projections of Federal Reserve Governors and Reserve Bank presidents in the Monetary Policy Report to the Congress from the previous July.

Forecast errors: core PCE inflation



Source: Federal Reserve Board. Economic projections of Federal Reserve Governors and Reserve Bank presidents in the Monetary Policy Report to the Congress from the previous July.

A key growth issue for the tapering debate

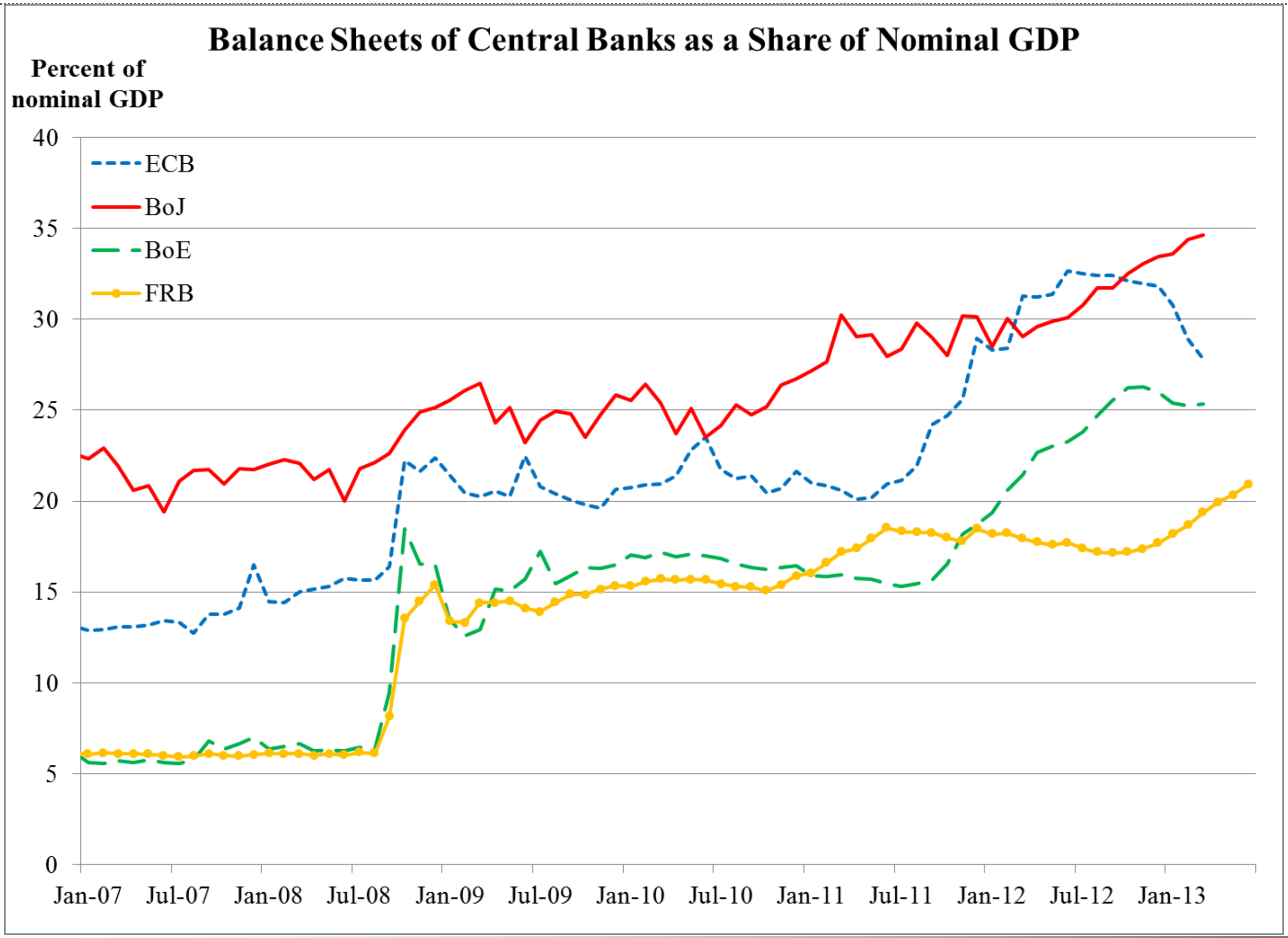
- Should the Committee focus attention primarily on recent growth performance, or on future projected growth?
  - If the former, then growth has been weak in recent quarters, although it now appears the second quarter may have been stronger than previously thought.
  - If the latter, then growth may be judged to be improving, but forecasting performance for real GDP has been poor over the last several years.

The Size of the Fed's Balance Sheet

The size of the Fed's balance sheet

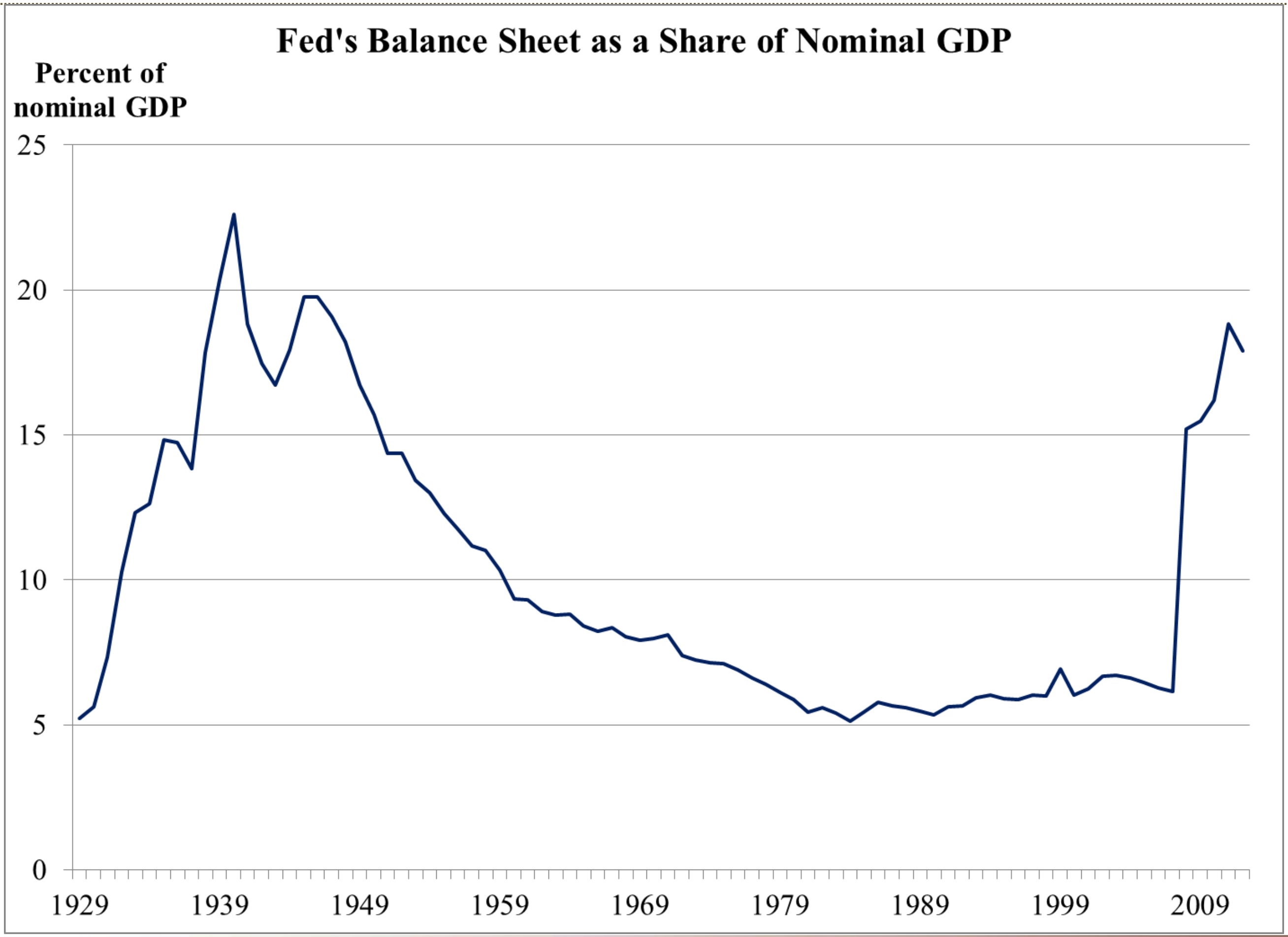
- The Fed's balance sheet is large by the standards of the last several decades.
- The large balance sheet has been viewed as posing risks to the Committee's exit from unconventional policy.
- However, the balance sheet is not particularly large when scaled by GDP and compared to other major central banks, or when compared to historical data on the Fed's balance sheet.

Balance sheets: Fed and other major central banks



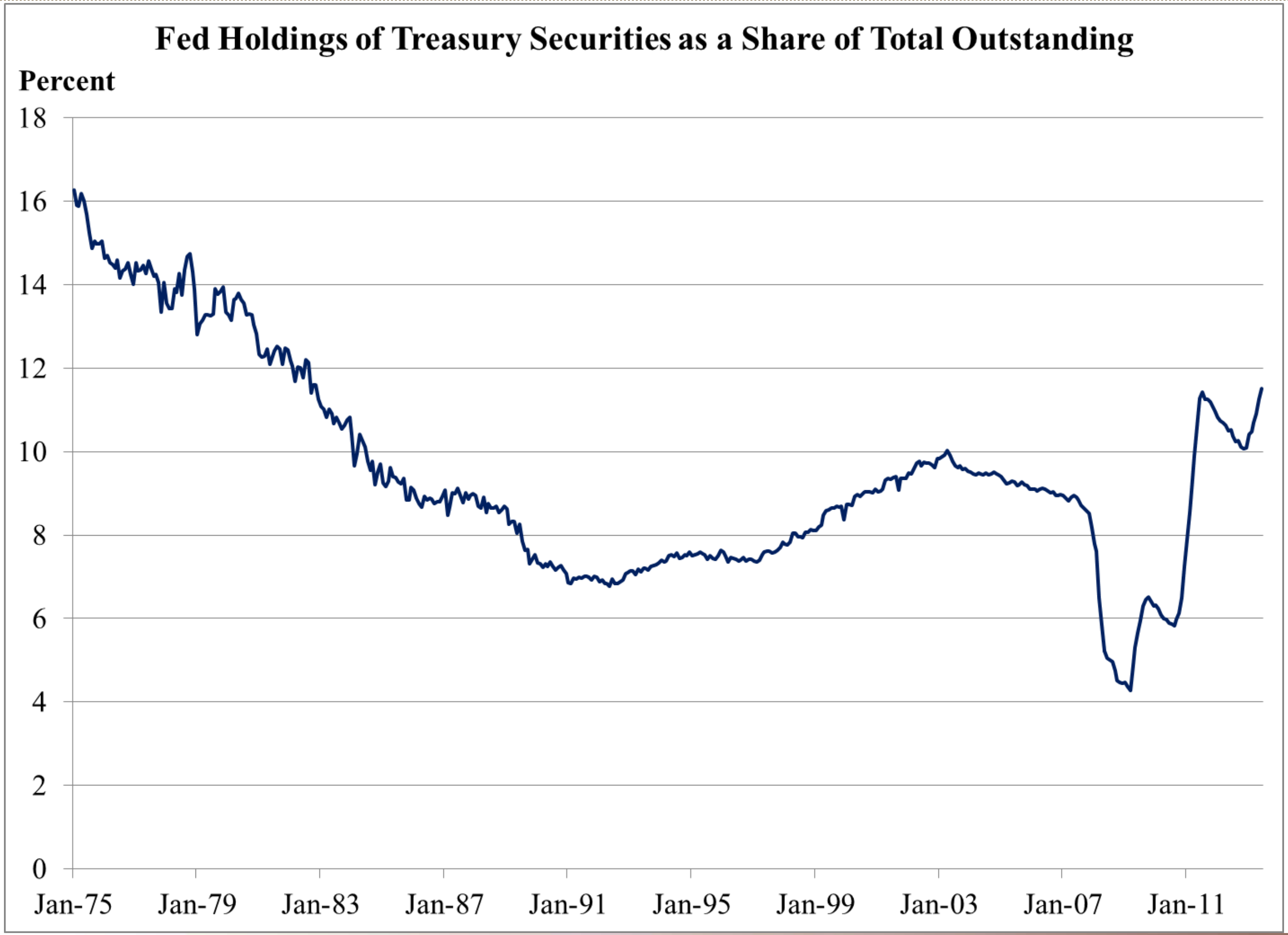
Source: Haver Analytics and author's calculations. Last observation: June 2013 (FRB), March 2013 (others).

Fed's balance sheet relative to GDP



Source: Historical Statistics of the United States, BEA, and author's calculations. Last observation: 2012.

Fed holdings of Treasury securities



Source: Federal Reserve Board, Department of the Treasury, and author's calculation. Last observation: June 2013.

A key balance sheet issue for tapering

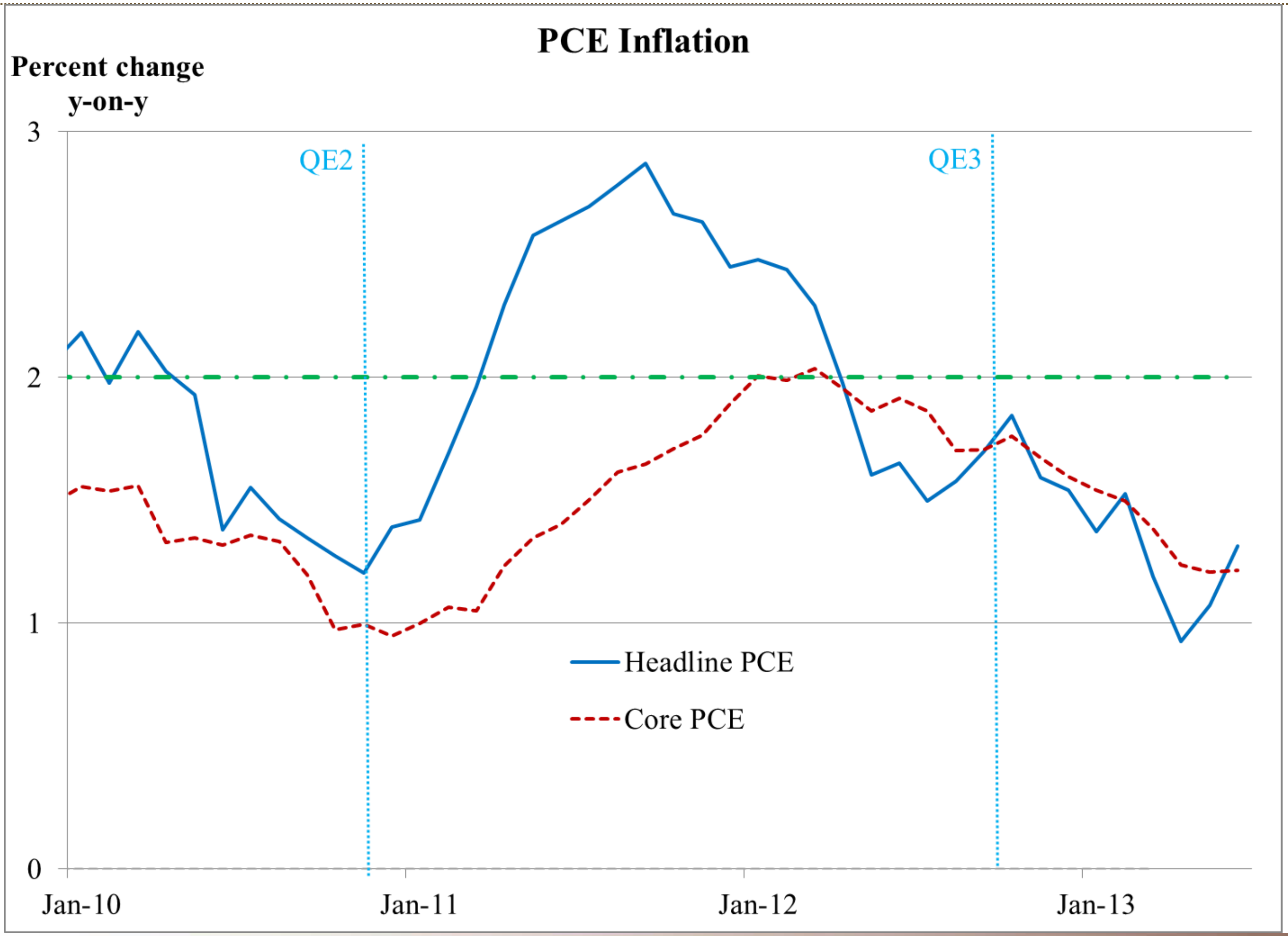
- Should the Committee be more concerned about its exit strategy when the size of the balance sheet relative to GDP is 30 percent versus 20 percent?
  - If yes, then balance sheet size may be judged a constraint at some point in the future.
  - If no, then exit is equally difficult if the balance sheet is 30 percent or 20 percent of GDP, and the Committee need not view balance sheet size as a constraint going forward.

Inflation

Recent inflation developments

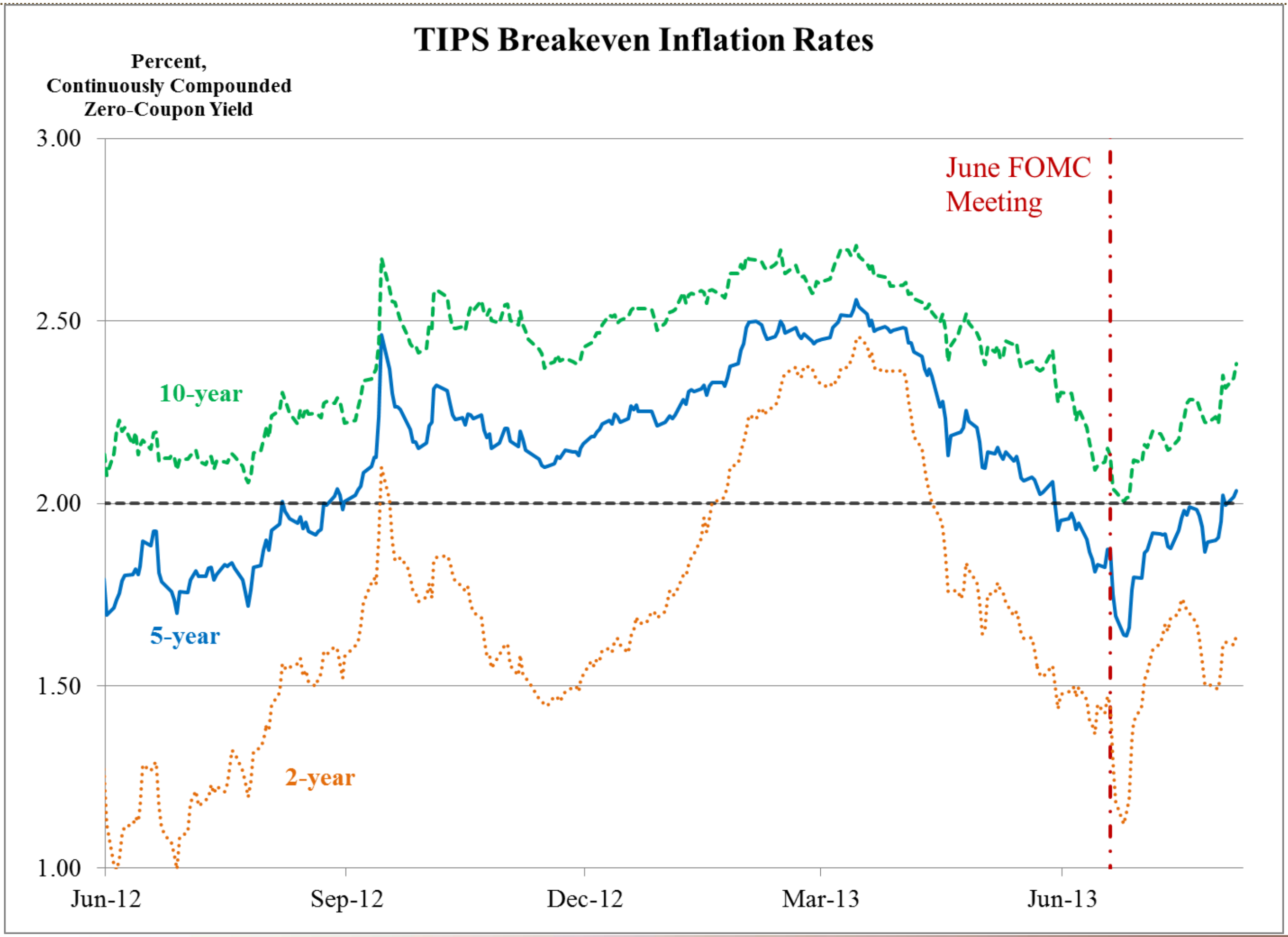
- The Committee would not normally remove policy accommodation in an environment where inflation is below target and is projected to remain there.
- Current inflation is low.
- On balance, inflation expectations have declined since March, although they have increased from recent lows.

PCE inflation



Source: Bureau of Economic Analysis. Last observation: June 2013.

Inflation expectations have declined since March



Source: Federal Reserve Board. Last observation: August 6, 2013.

Why has inflation been low?

- We do not have a good explanation, so we should be careful.
- One sketch of a theory:
  - Commodity prices globally have been soft over the last year.
  - This may be due in part to the recession in Europe, coupled with slower-than-expected growth in China.
  - This may have fed through to core inflation in the U.S.
- Core PCE inflation near 1 percent measured from a year earlier is near the lower edge of acceptable outcomes.

A key inflation issue for the tapering debate

- Will current low levels of PCE inflation naturally move up toward 2 percent in the coming months and quarters?
  - If yes, then current low inflation readings are an aberration and the Committee can reduce the pace of asset purchases without worrying about pushing inflation even further below target.
  - If no, then inflation may be pushed even lower by a decision to taper and hence the risk of deflation may increase.

Conclusions

A press conference at every meeting?

- The tapering debate is currently centered on the September and December meetings of the FOMC.
- What about the October meeting?
- The October meeting does not have a press conference scheduled and so is thought to be an unlikely venue for important policy action.
- The FOMC should make all meetings *ex ante* identical so that key decisions can be made at any juncture.
- This would allow the Committee to better align appropriate decisions with incoming macroeconomic data.

Conclusions

- I have suggested some key questions for the tapering debate in the following areas: Labor market performance, growth, balance sheet size, and inflation.
- The resolution of the tapering debate will depend on additional macroeconomic data from the second half of 2013.
- It is especially important to see if better macroeconomic growth materializes in the months and quarters ahead, and whether inflation naturally returns toward target.

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