Four Questions for Current Monetary Policy

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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

- Four interesting questions for current monetary policy:
  - Is QE an effective way to conduct monetary stabilization policy?
  - Are FOMC decisions about QE tapering data dependent?
  - Does cumulative progress in labor market outcomes since September 2012 matter for QE tapering?
  - Do current low inflation readings suggest that the Committee can be patient in assessing the QE program?

- All of these questions have the same answer: "Yes."

Question One: QE Effectiveness

QE effectiveness

- Is QE an effective way to conduct conventional monetary stabilization policy when the policy rate is at the zero lower bound?
- Yes.
- Consider two recent cases:
  - The June 2013 FOMC meeting, in which the Committee leaned toward an earlier-than-expected reduction in the pace of purchases.
  - The just-completed September 2013 FOMC meeting, in which the Committee delayed tapering.

The argument for effectiveness

- In June 2013, the policy decision was more hawkish than markets expected before the meeting.
- In September 2013, the policy decision was more dovish than expected before the meeting.
- Many of my friends in academia and in financial markets argue that changes in the pace of purchases should not have an important effect in financial markets (and hence would have no eventual effect on the real economy either).
- However, *the empirical evidence from these two episodes provides striking confirmation that changes in the expected pace of purchases act just like conventional monetary policy*.

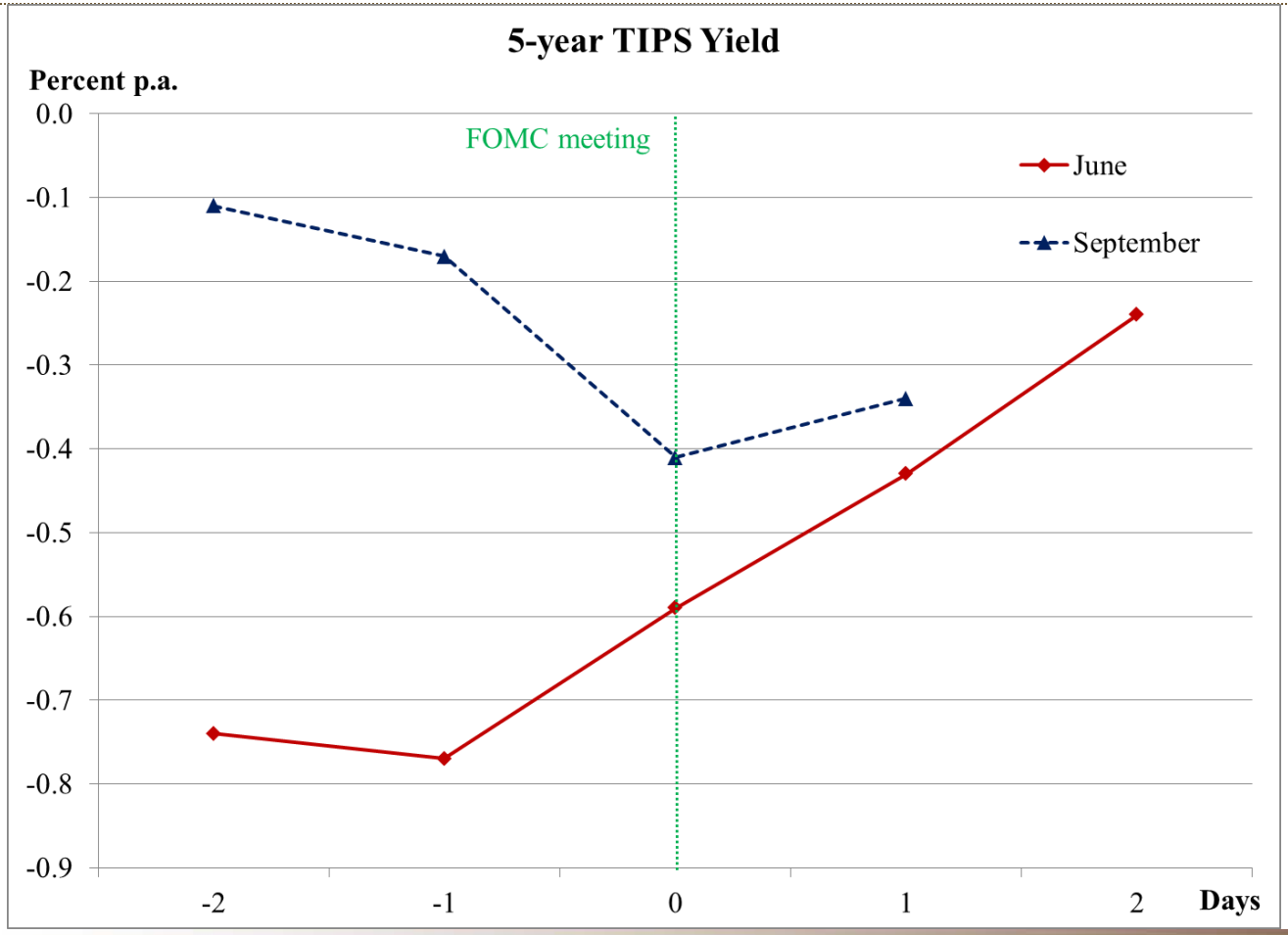
Conventional policy effects

- In normal times, the FOMC would adjust the expected path of the policy rate upward or downward depending on macroeconomic circumstances.
- An easier-than-expected policy path would (1) lower real interest rates, (2) raise inflation expectations, (3) increase equity prices, and (4) depreciate the dollar.
- A tighter-than-expected policy path would have the opposite effects.
- The changes in the expected pace of purchases at the June and September FOMC meetings had exactly the same effects as conventional monetary policy.

Conclusion on effectiveness

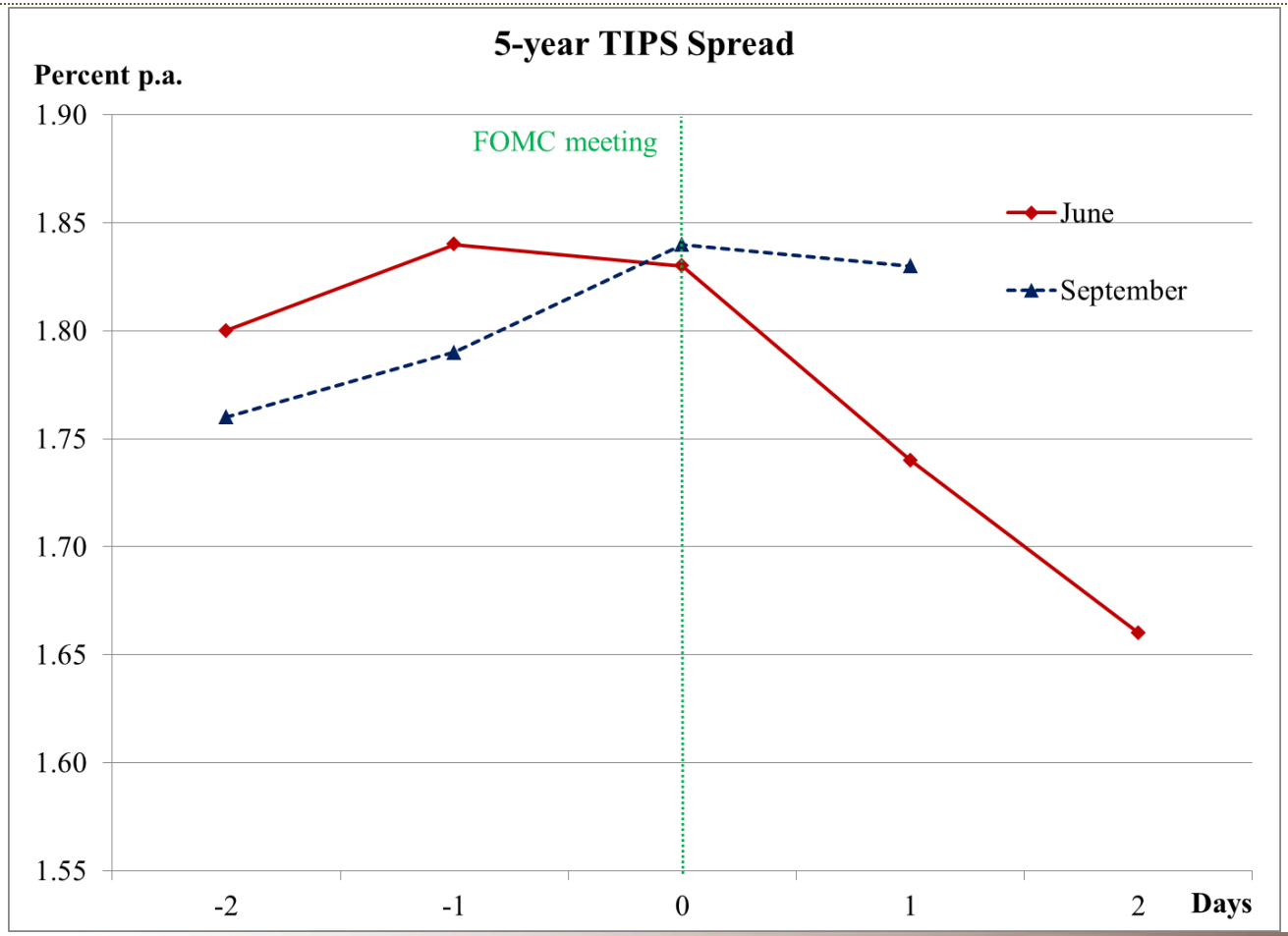
- Changes in the expected pace of purchases at the June and September FOMC meetings had the same financial market effects as would have occurred had the Committee been able to change the policy rate path directly.
- I conclude that using the pace of purchases as the policy instrument is just as effective as normal monetary policy actions would be in normal times.
- In other words, QE is an effective way to conduct monetary stabilization policy.

Real interest rate



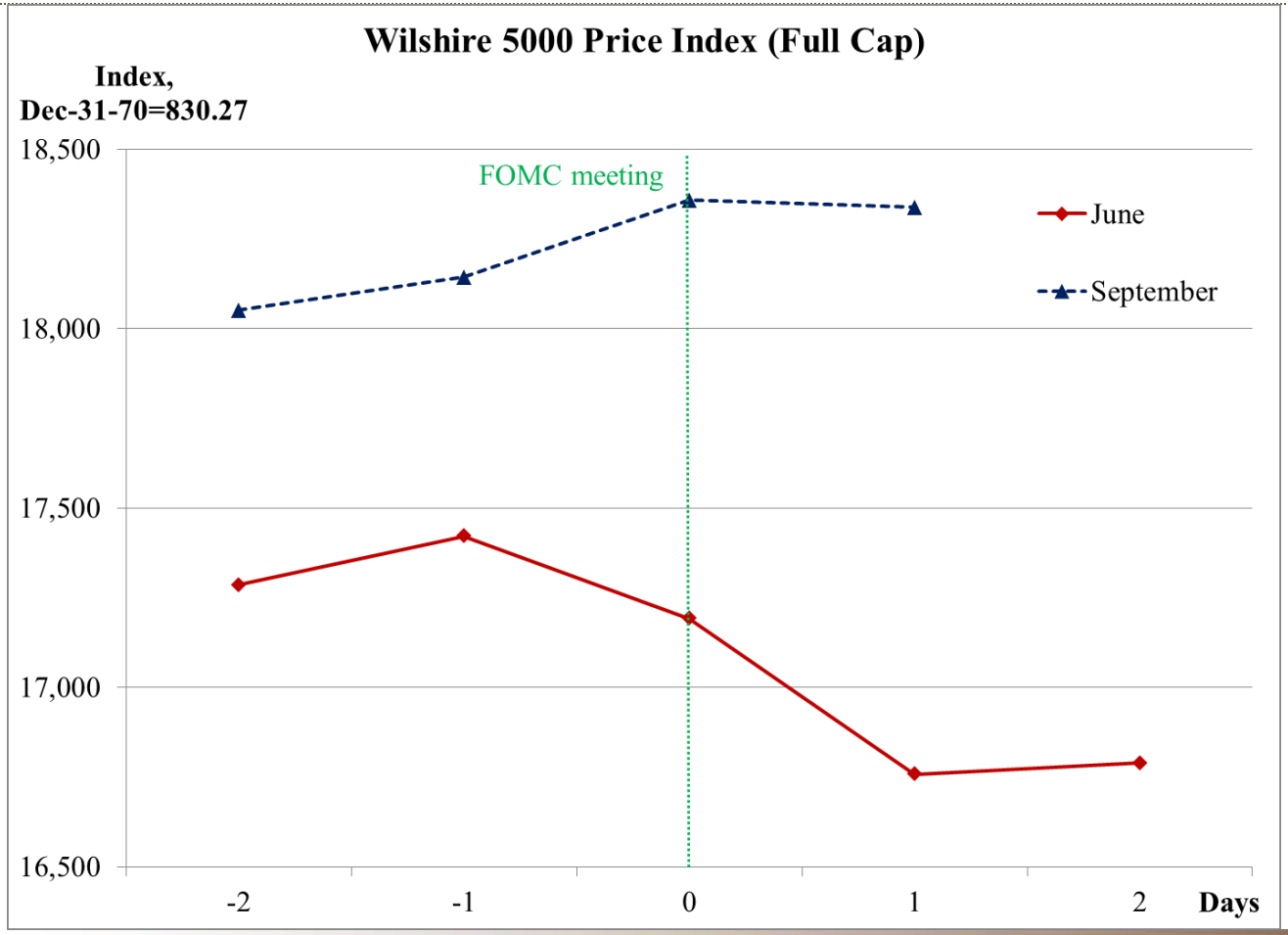
Source: Federal Reserve Board. Last observation: September 19, 2013.

Expected inflation



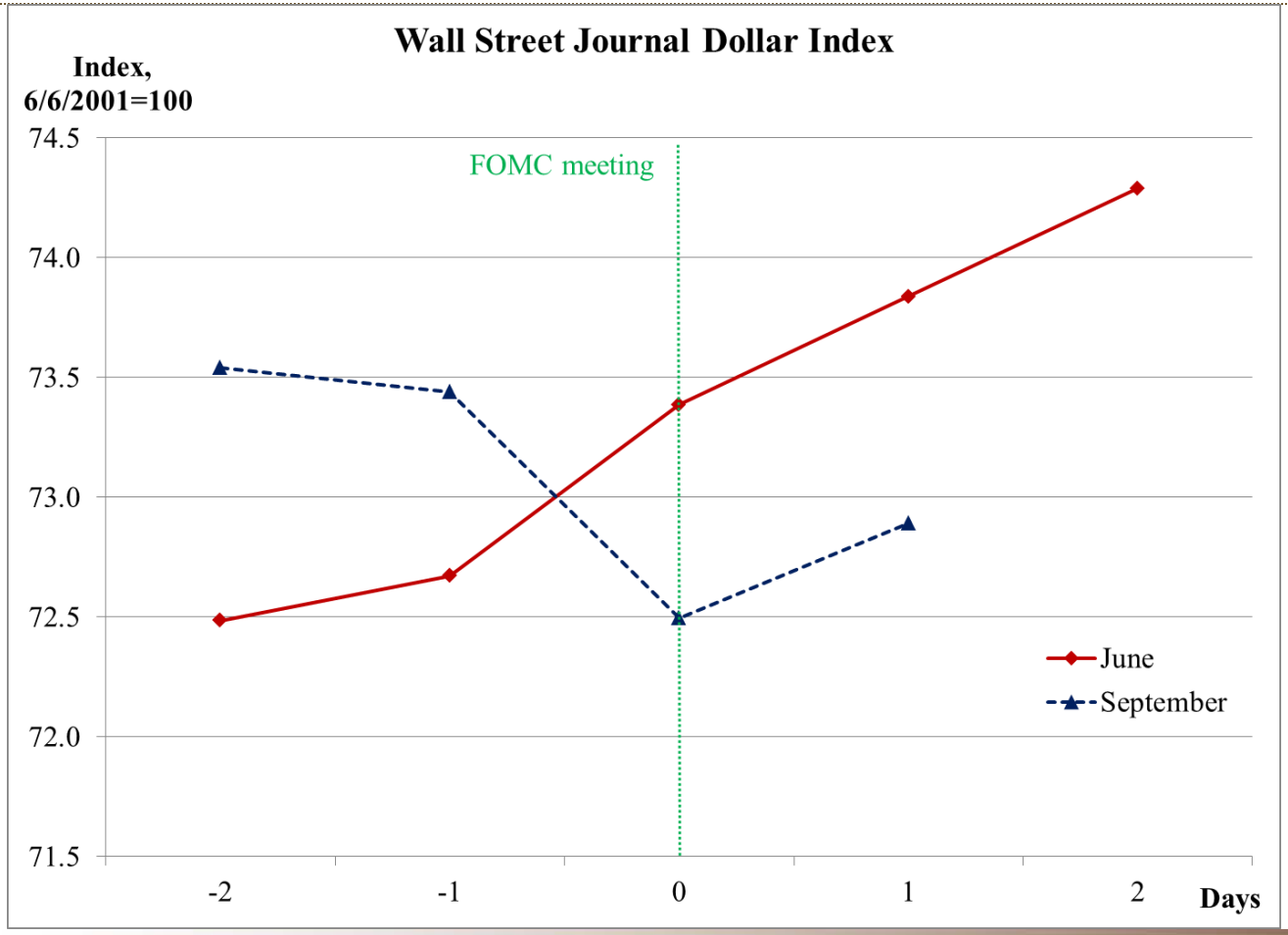
Source: Federal Reserve Board. Last observation: September 19, 2013.

Equity prices



Source: Dow Jones. Last observation: September 19, 2013.

Exchange rate



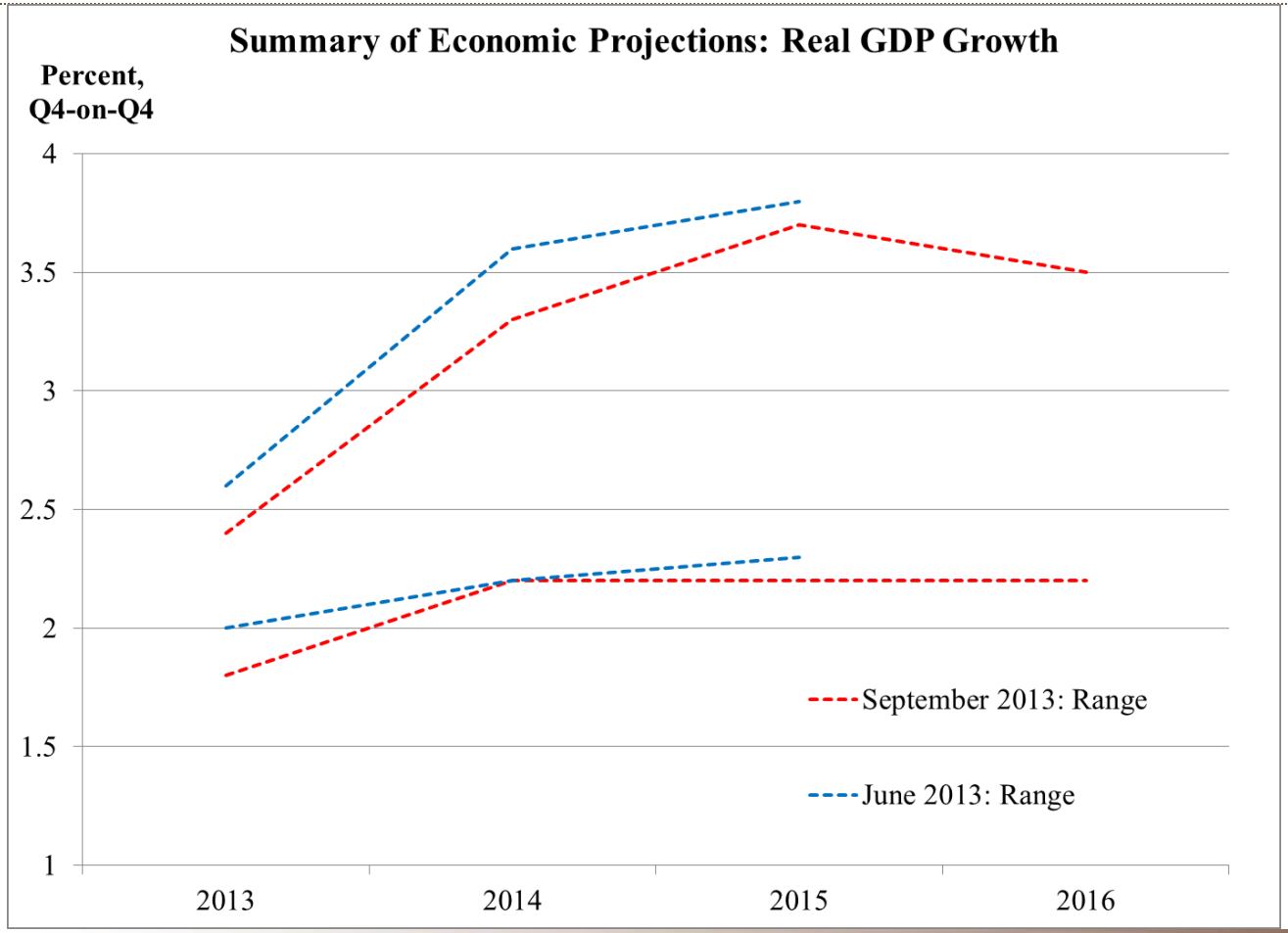
Source: Wall Street Journal. Last observation: September 19, 2013.

Question Two: QE Data Dependence

Data dependence and QE

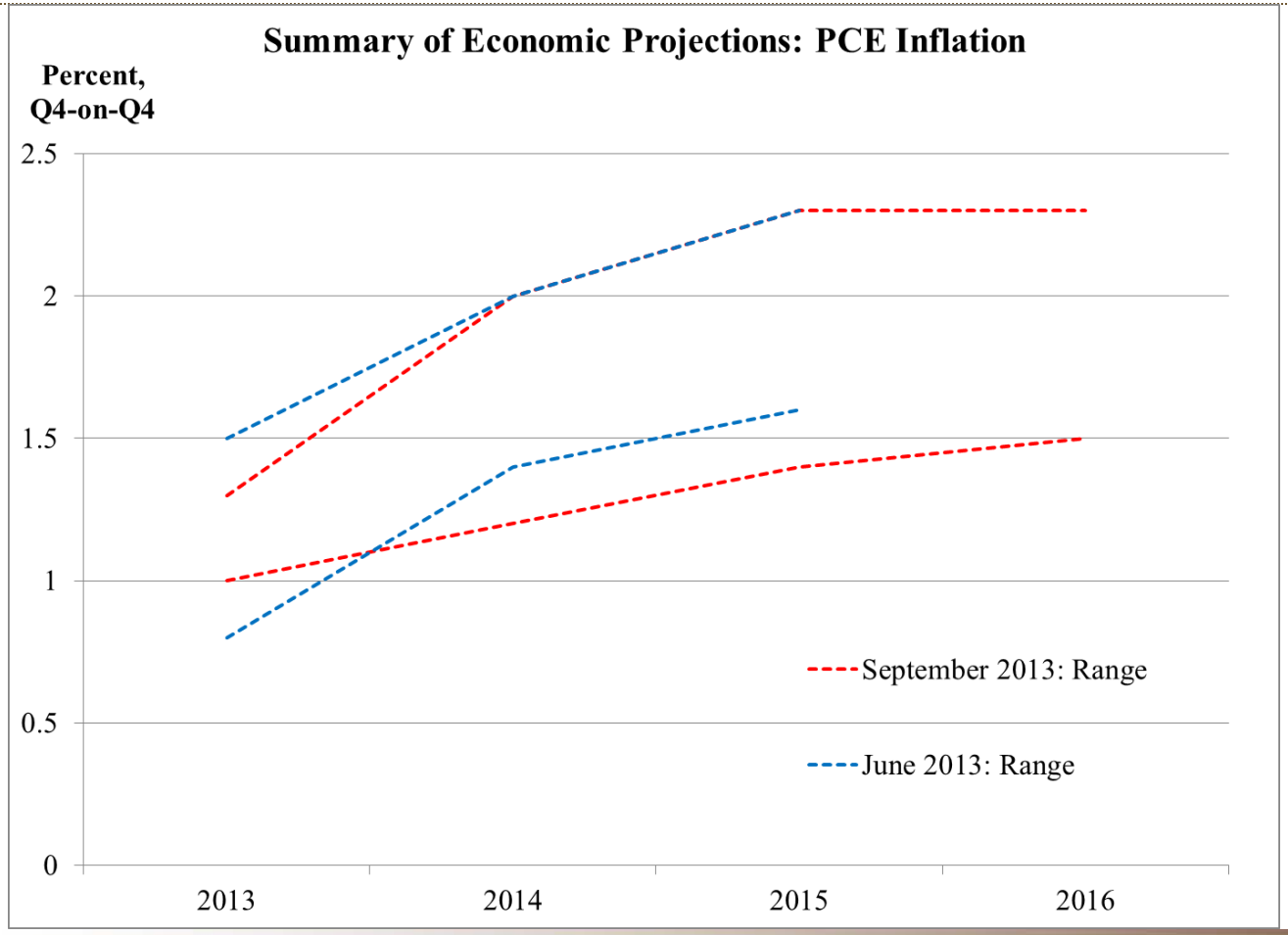
- Are FOMC decisions about QE tapering data dependent?
- Yes.
- The Chairman has repeatedly emphasized that decisions on the pace of tapering depend on incoming macroeconomic data.
- This was illustrated by the recent FOMC decision to delay tapering.
- At the meeting, the Committee downgraded its assessment of forecast real GDP growth for 2013 and 2014, and simultaneously reduced its expectations for inflation.
- Normally, the Committee would not want to reduce policy accommodation in this situation.

Real GDP growth forecasts



Source: Federal Reserve Board. Last observation: September 18, 2013.

PCE inflation forecasts



Source: Federal Reserve Board. Last observation: September 18, 2013.

Conclusion on data dependence

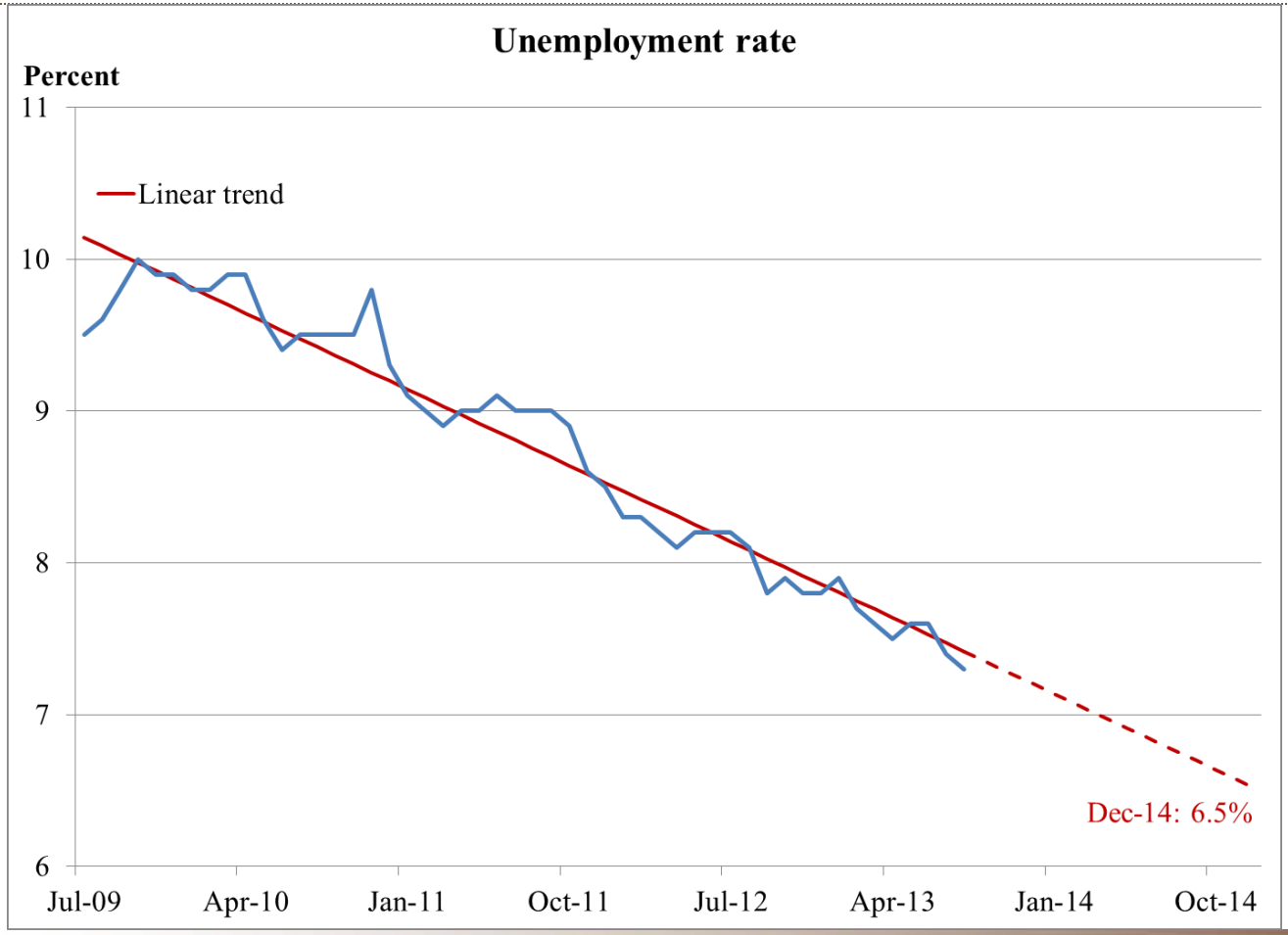
- The Committee downgraded its outlook at the September meeting relative to the June meeting.
- This reflected weaker-than-expected data during the intermeeting period.
- The June narrative, that the second half of 2013 would display strong growth, was called into question.

Question Three: Cumulative Progress

Cumulative progress in labor markets

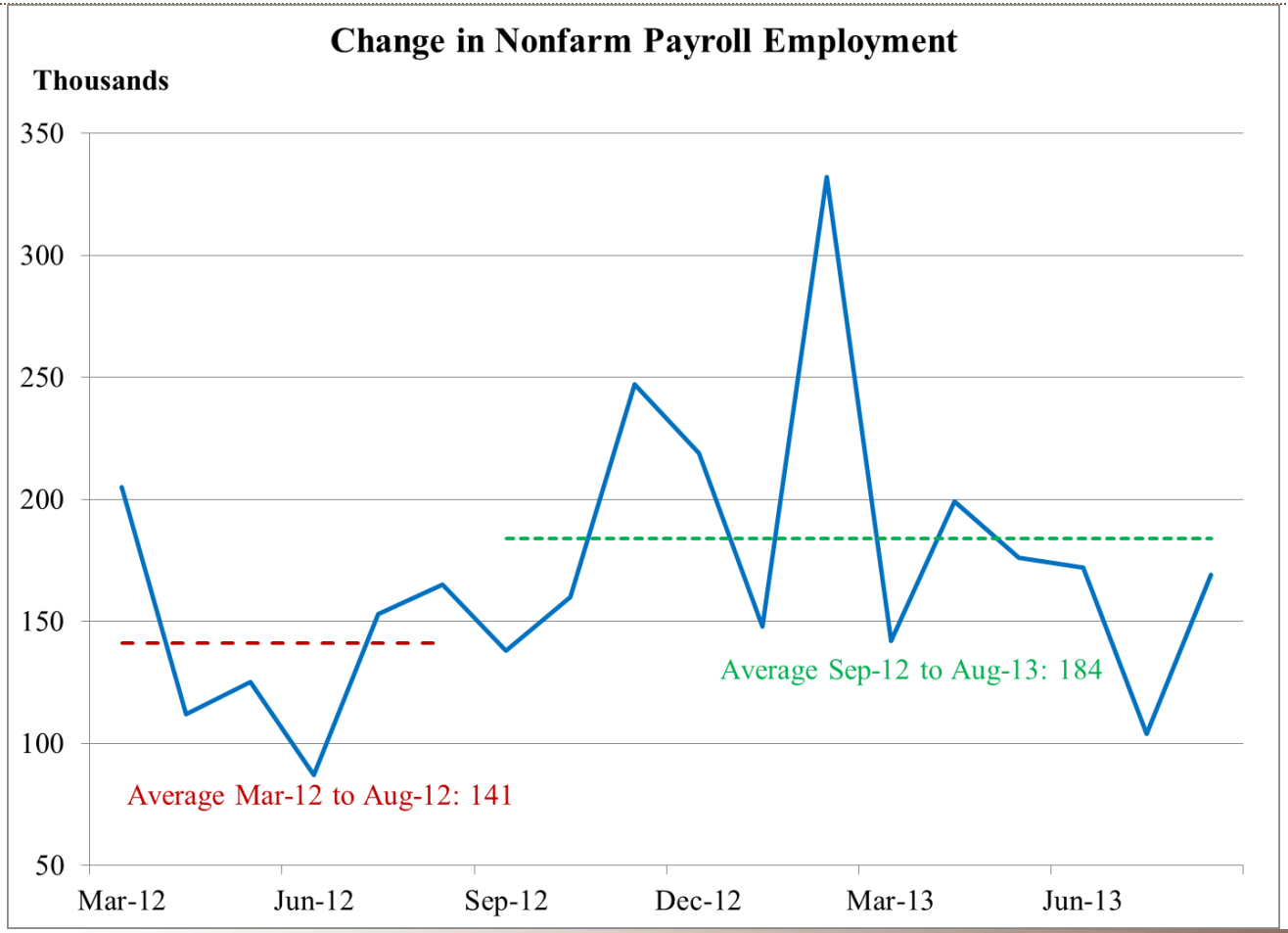
- Does cumulative progress in labor market outcomes since September 2012 matter for QE tapering?
- Yes.
- When the Committee started the QE program in September 2012, the stated goal was substantial improvement in labor market outcomes.
- Two key labor market indicators have shown clear improvement over the last year: Unemployment and nonfarm payrolls.

Unemployment rate



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

Nonfarm payroll employment



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

Conclusion on cumulative progress

- To the extent that these two important labor market indicators continue to show improvement, the likelihood of tapering policy action will continue to rise.

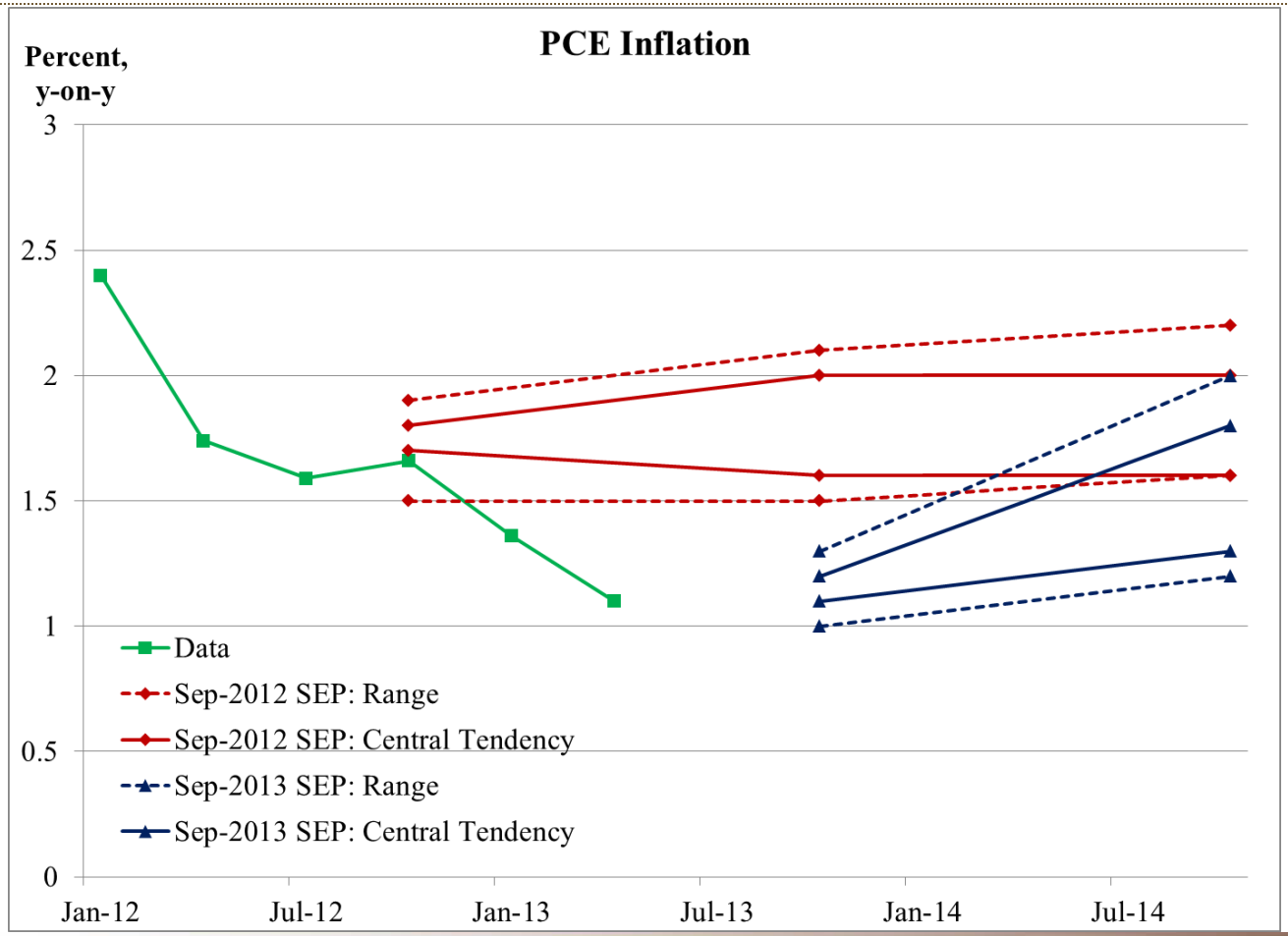
- But ….

Question Four: Inflation

Low inflation and QE

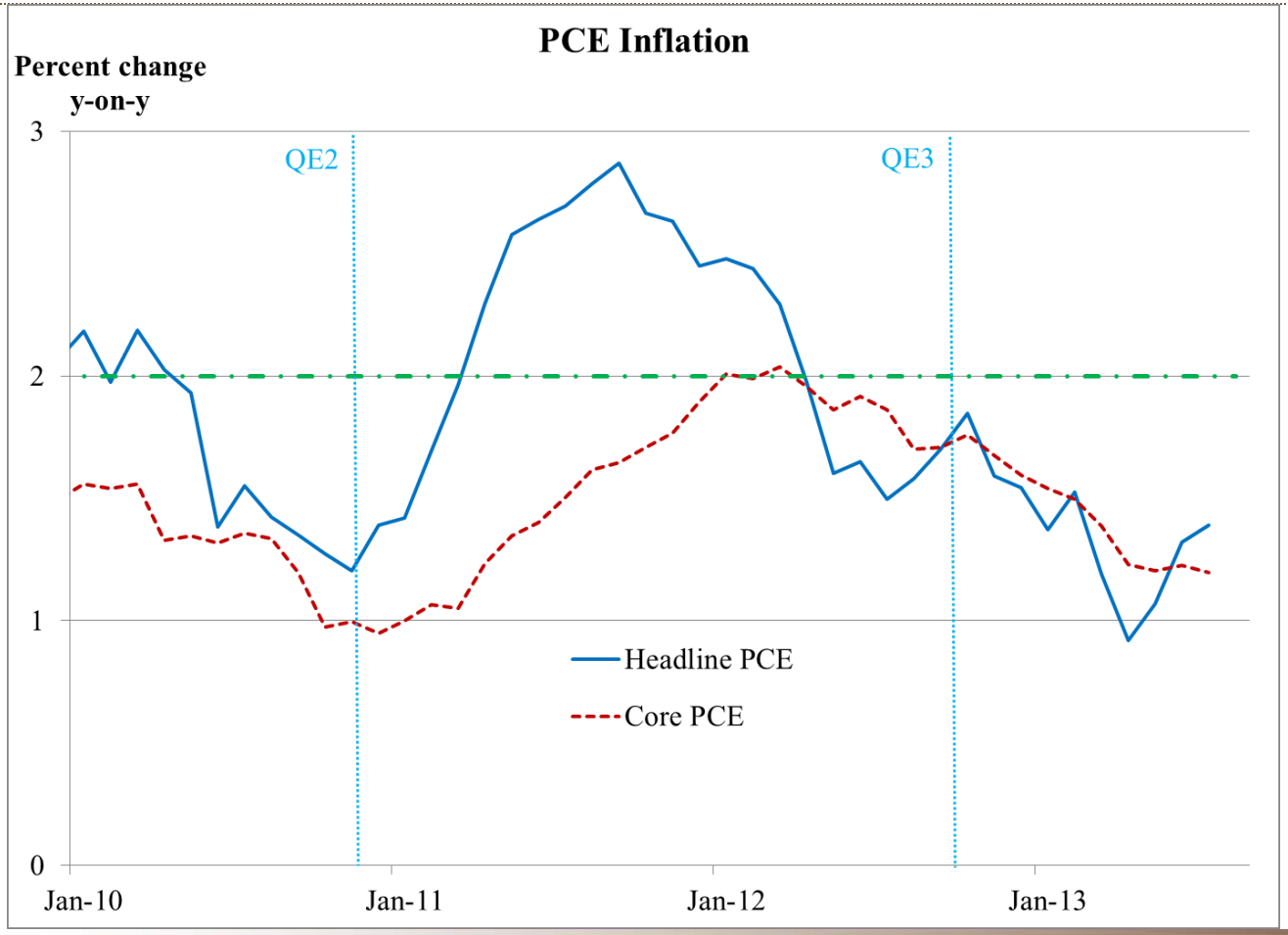
- Do current low inflation readings suggest that the Committee can be patient in assessing the QE program?
- Yes.
- The main macroeconomic surprise in the U.S. since September 2012 has been a lower rate of inflation.
- Near-term inflation expectations measured from the TIPS market suggested little inflation pressure before the recent FOMC meeting.
- While I expect inflation to rise during the coming quarters, I want to see evidence of such an increase before endorsing less accommodative policy action by the FOMC.

PCE inflation and SEP forecasts



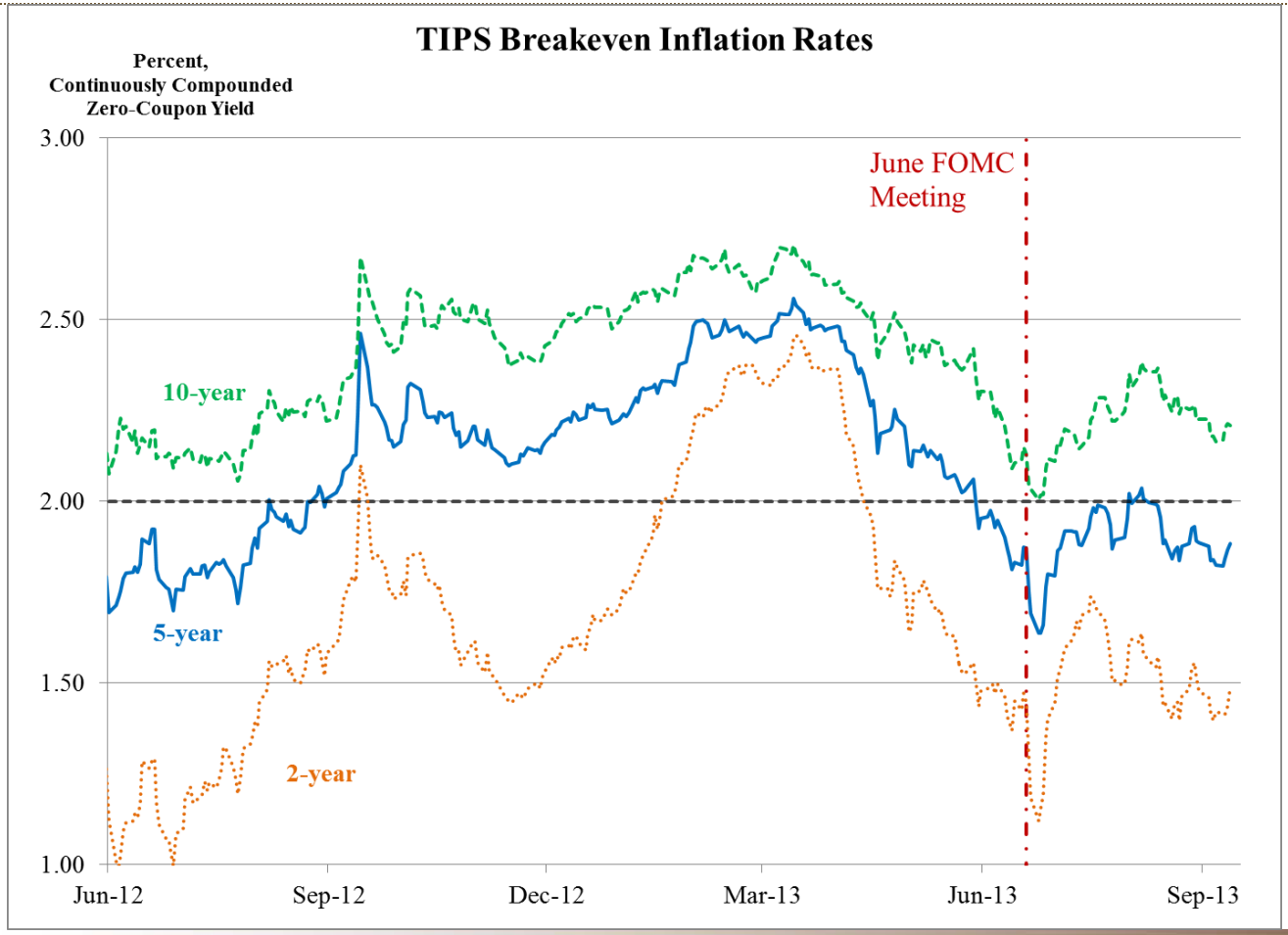
Source: Bureau of Economic Analysis and Federal Reserve Board. Last observations: 2013-Q2 and September 18, 2013.

PCE inflation



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

Inflation expectations have declined since March



Source: Federal Reserve Board. Last observation: September 13, 2013.

Conclusion

Conclusions

- Financial market reaction to the June and September FOMC meetings provides sharp evidence that changes in the expected pace of asset purchases have conventional monetary policy effects.
- The September FOMC decision illustrates that tapering decisions are data dependent.
- Continued cumulative labor market gains relative to September 2012 increase the probability of tapering.
- Relatively low inflation readings allow the Committee to be patient in assessing the future of asset purchases.

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