U.S. Monetary Policy: Easier Than You Think It Is

James Bullard

President and CEO, FRB-St. Louis

Mississippi State University

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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

- U.S. monetary policy has changed recently.
- I will describe some of the recent changes and my view of how the stance of monetary policy has been altered.
- I will argue that the current stance of U.S. monetary policy is considerably easier than it was in 2012.

Two aspects of current U.S. monetary policy

- Nominal interest rate policy
  - The policy rate has been near zero since December 2008.
  - The Federal Open Market Committee (FOMC) has promised to maintain the near-zero rate into the future, so-called "forward guidance."
  - The Committee has replaced fixed-date forward guidance with a "threshold" approach.
- Balance sheet policy
  - The Committee has promised to maintain an aggressive asset purchase program.

Why is monetary policy easier today than in 2012?

- On interest rate policy:
  - The threshold approach has disposed of the "pessimistic signal" that was a side effect of the date-based forward guidance.
  - This should make the forward guidance more effective.

- On balance sheet policy:
  - The Committee's outright asset purchases replaced the "Operation Twist" program.
  - The twist program may not have been as effective as hoped.
  - Open-ended outright purchases are a more potent tool.

Why is monetary policy easier today versus 2012?

- In sum:
  - 2012 policy was characterized by a relatively weak "Operation Twist" program combined with somewhat counterproductive date-based forward guidance.
  - 2013 is characterized by a relatively potent open-ended outright asset purchase program combined with more effective threshold-based forward guidance.
  - End result: Considerably easier U.S. monetary policy.

Thresholds and the Policy Rate

Thresholds

- The Committee previously used a given date to indicate when the first increase in the policy rate will likely occur.
  - This approach has some problems.
- In December the Committee instead adopted “thresholds,” values for inflation (2.5 percent) and unemployment (6.5 percent) that give an indication that the time for a policy rate increase may have arrived.
- This is a more state-contingent policy.
  - “State-contingent” means “dependent on economic conditions.”

The pessimism problem

- The Committee previously stated that the policy rate will likely remain near zero until "mid-2015."

- This created a "pessimism problem" for the Committee.
  - The date could 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 counterproductive.
  - The Committee did not intend to send such a signal.

Fixing the pessimism problem

- The Committee has now switched to a description of economic conditions at the time of the first rate increase.

- Now, as data arrive on U.S. economic performance, private sector expectations concerning the timing of the first rate increase can automatically adjust.
  - Vice Chair Yellen has called this an "automatic stabilizer."

- The Committee is no longer sending the pessimistic signal, because the threshold conditions can be met at any time.

Thresholds have some challenging aspects

- The use of thresholds is not a panacea.

- I have described elsewhere a number of issues that the Committee is likely to face going forward with this strategy, including:
  - The FOMC cannot pretend to target medium- or long-term unemployment.
  - The Committee needs to reiterate that it considers many more variables in attempting to gauge the state of the U.S. economy.
  - The thresholds will likely be viewed as triggers for action.

Balance Sheet Policy

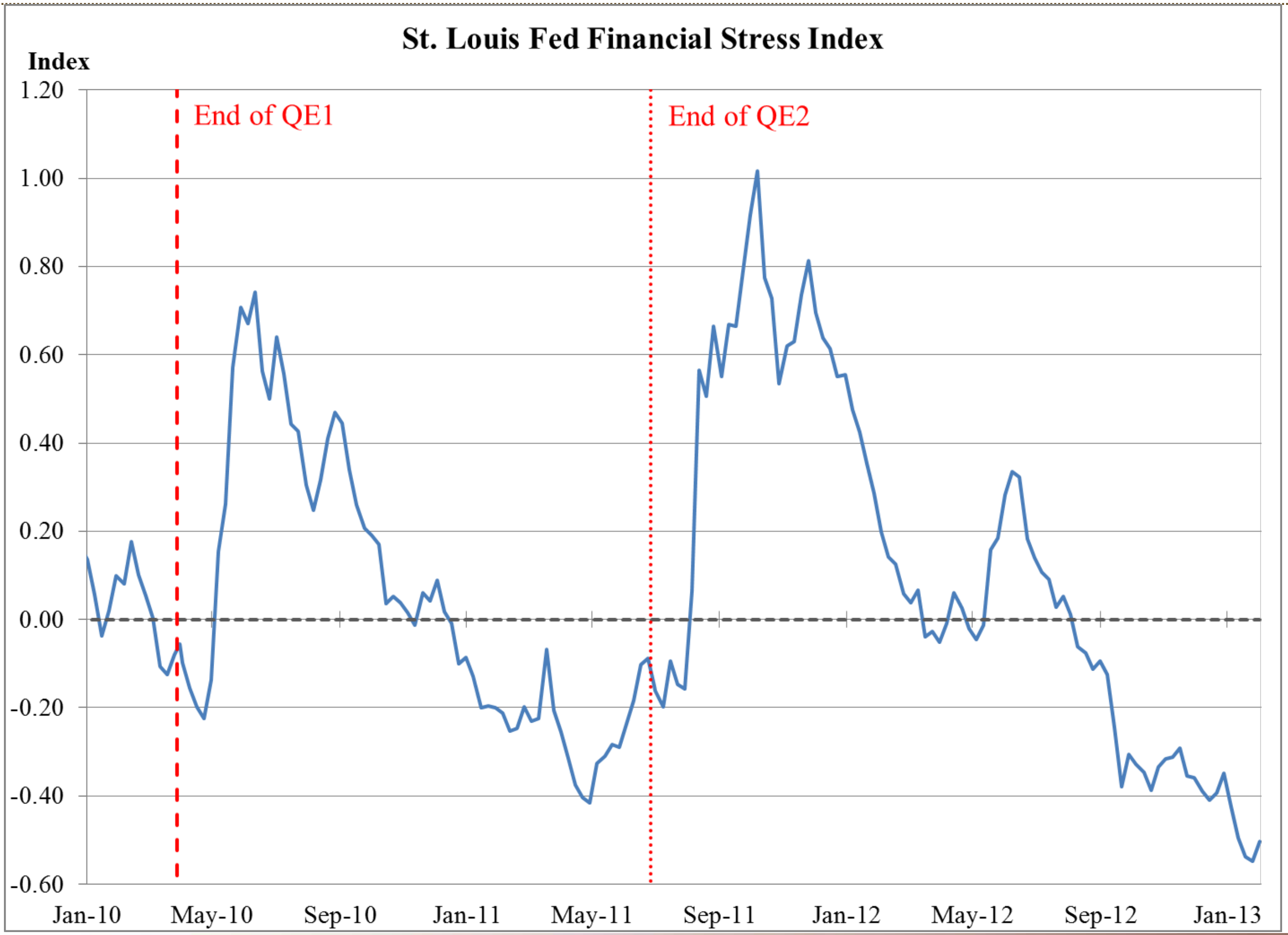
The FOMC balance sheet policy

- The Committee adopted "QE3" at the September 2012 meeting.
- This program is also more state-contingent, so-called "open-ended" QE.
  - Unlike previous programs, no end date was specified.
- This program was extended at the December meeting with the replacement of "Operation Twist" by outright purchases.
- The current approach is to purchase $40 billion in MBS and $45 billion in Treasury securities per month.
  - The annualized pace would be more than $1 trillion.

The end-date problem

- The Committee previously specified end dates for asset purchase programs.
- These end dates tended to occur at times which were characterized by relatively poor economic data.
  - Examples: March 2010, as the European sovereign debt crisis was heating up, and July 2011, as the debt ceiling debate was occurring.
- With QE3, the Committee instead seeks “substantial improvement” in labor markets before pausing purchases.
  - The Committee may also taper the program as needed.

Financial stress



Source: Federal Reserve Bank of St. Louis. Last observation: week of February 1, 2013.

No thresholds

- The Committee has maintained a qualitative approach to the state-contingent aspect of balance sheet policy.
  - Attempts to also put thresholds on the timing of asset purchases may be a bridge too far.
- The FOMC will have to make a judgment concerning the program as macroeconomic data arrive.
- Private sector expectations concerning the program will also adjust appropriately as data arrive.

How Long Can QE Continue?

Four considerations for the QE program

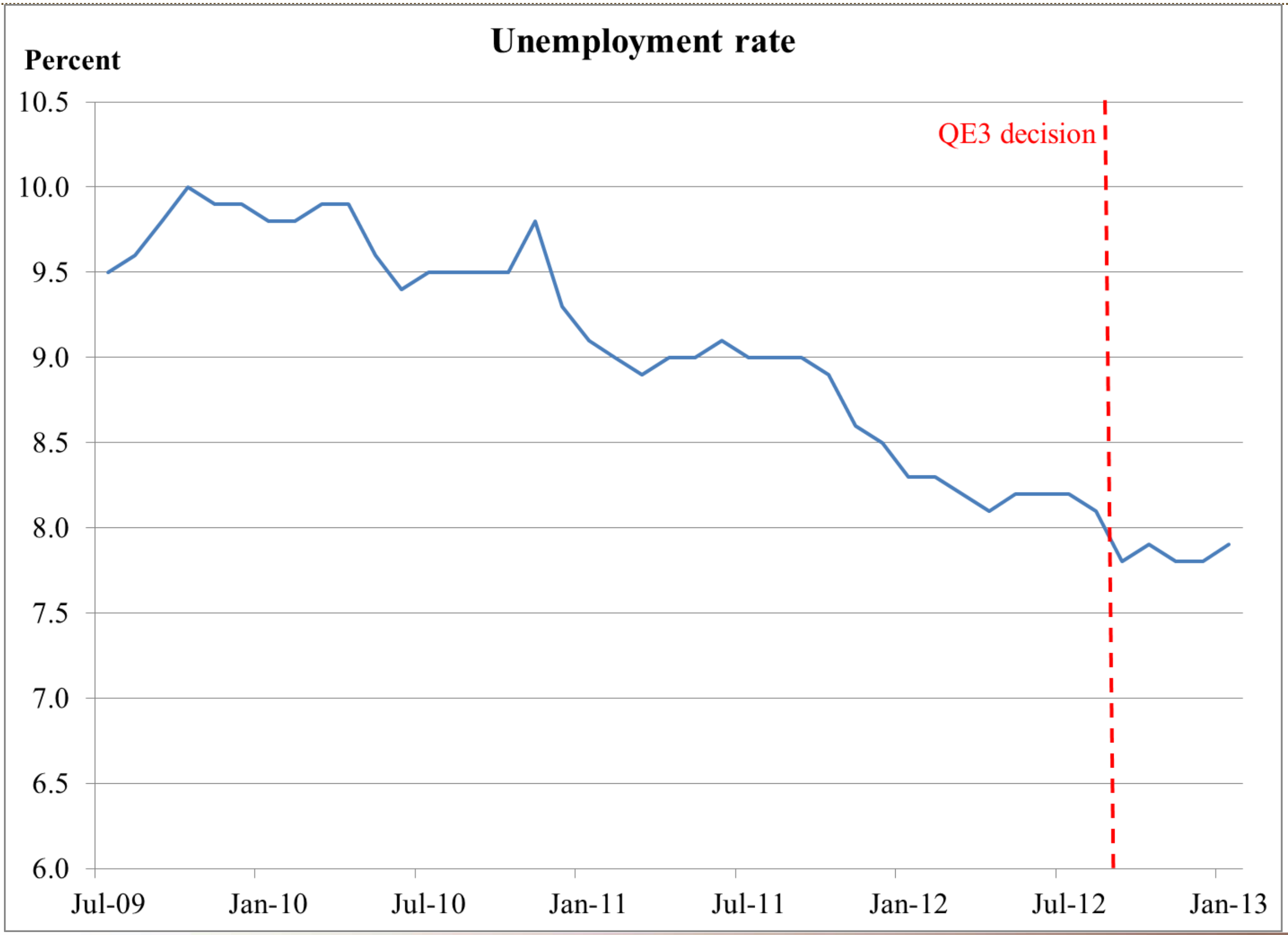
- The Committee has stated that it seeks "substantial improvement in labor markets" as a condition for ending the current asset purchase program.
- Without an end date, the Committee may have to alter the pace of purchases as news arrives concerning U.S. macroeconomic performance.
- Worries about rising inflation have so far been unfounded.
  - However, QE2 did change inflation and inflation expectations.
- The size of the balance sheet may complicate or prevent a graceful exit.

Substantial Labor Market Improvement

Many aspects of labor markets

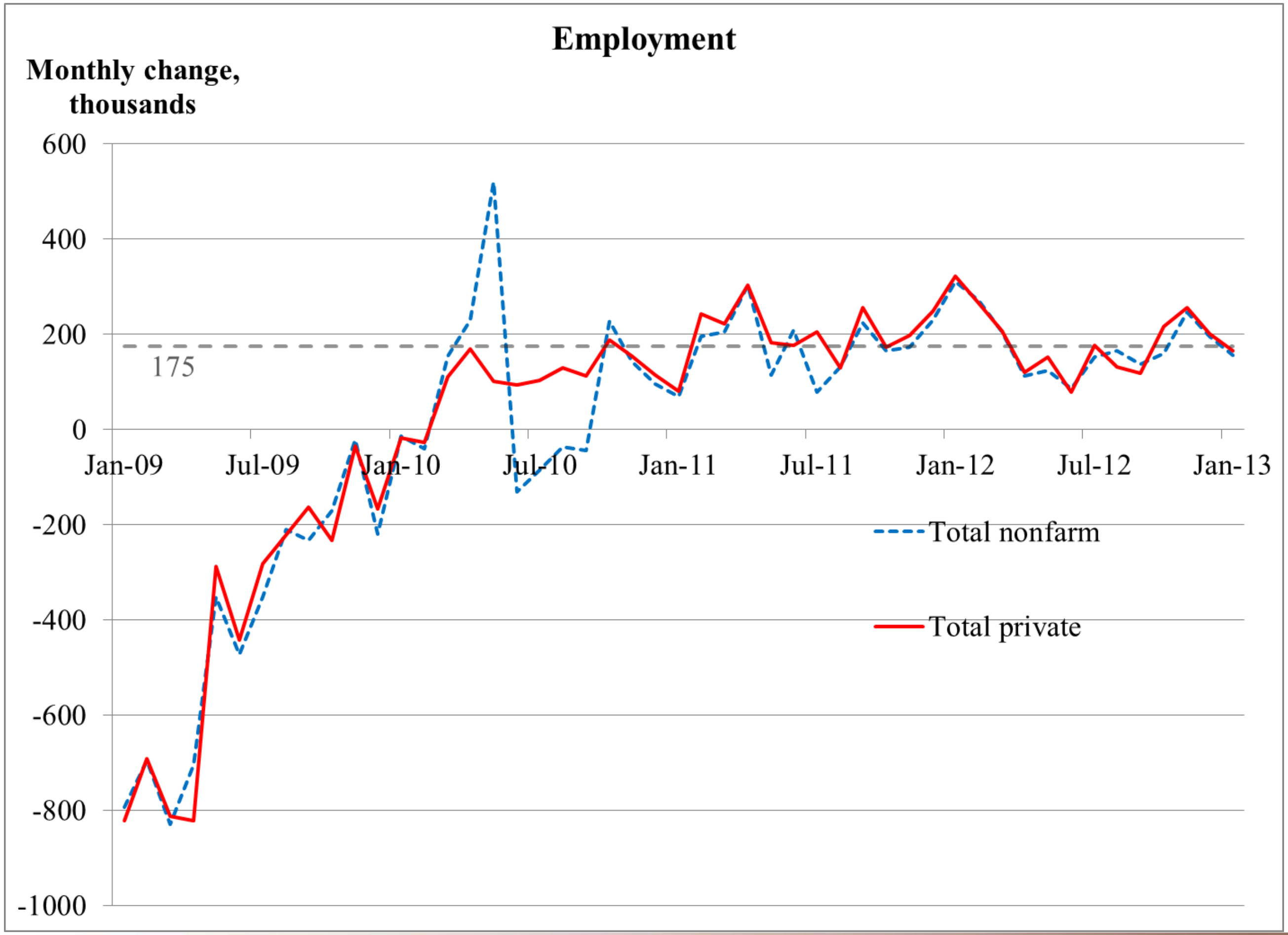
- The Committee could consider many different aspects of labor market performance when evaluating whether there has been "substantial improvement."
- Among these: Unemployment, employment, hours worked, and Job Openings and Labor Turnover Survey (JOLTS) data.

Unemployment



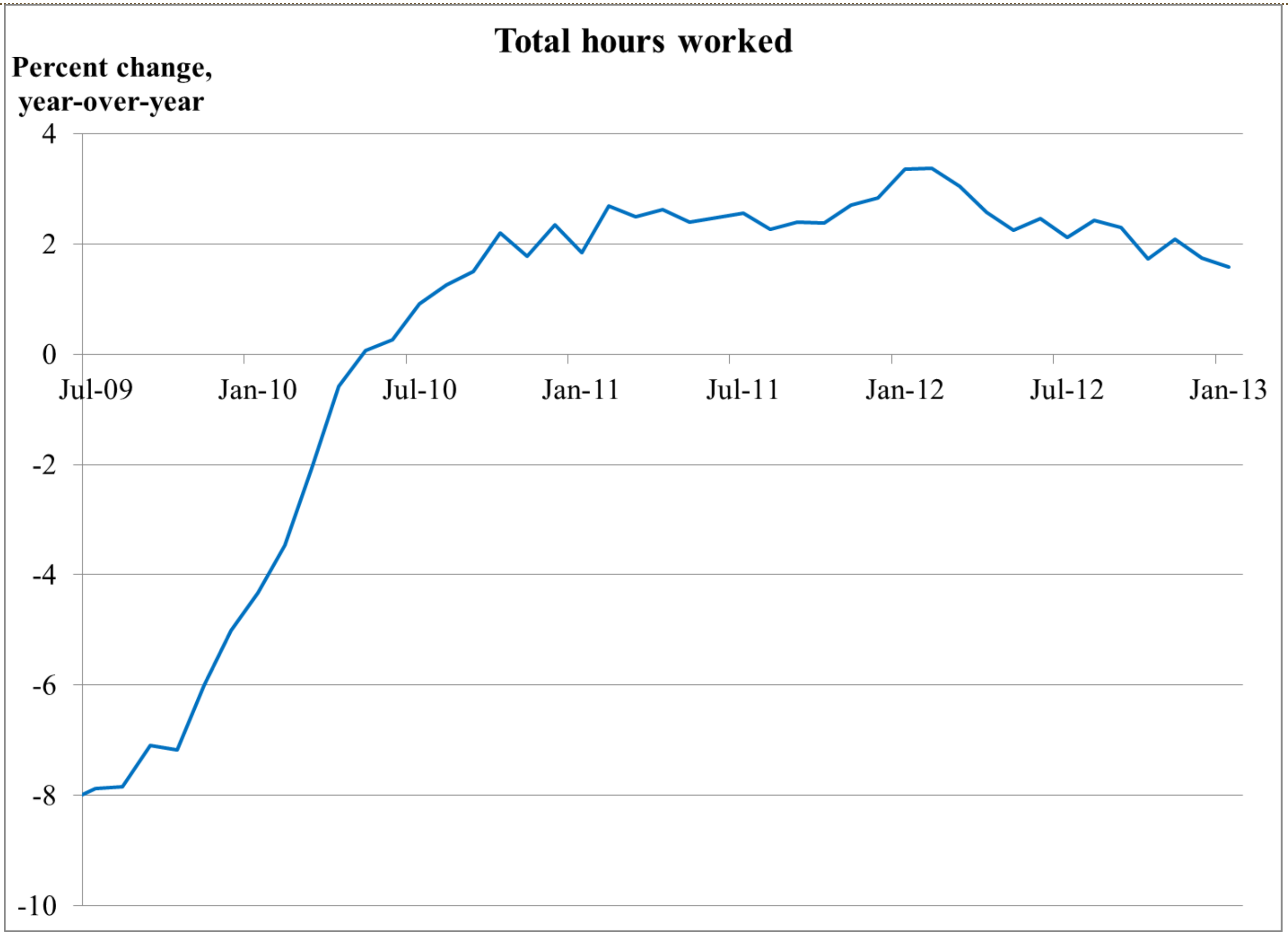
Source: Bureau of Labor Statistics. Last observation: January 2013.

Employment



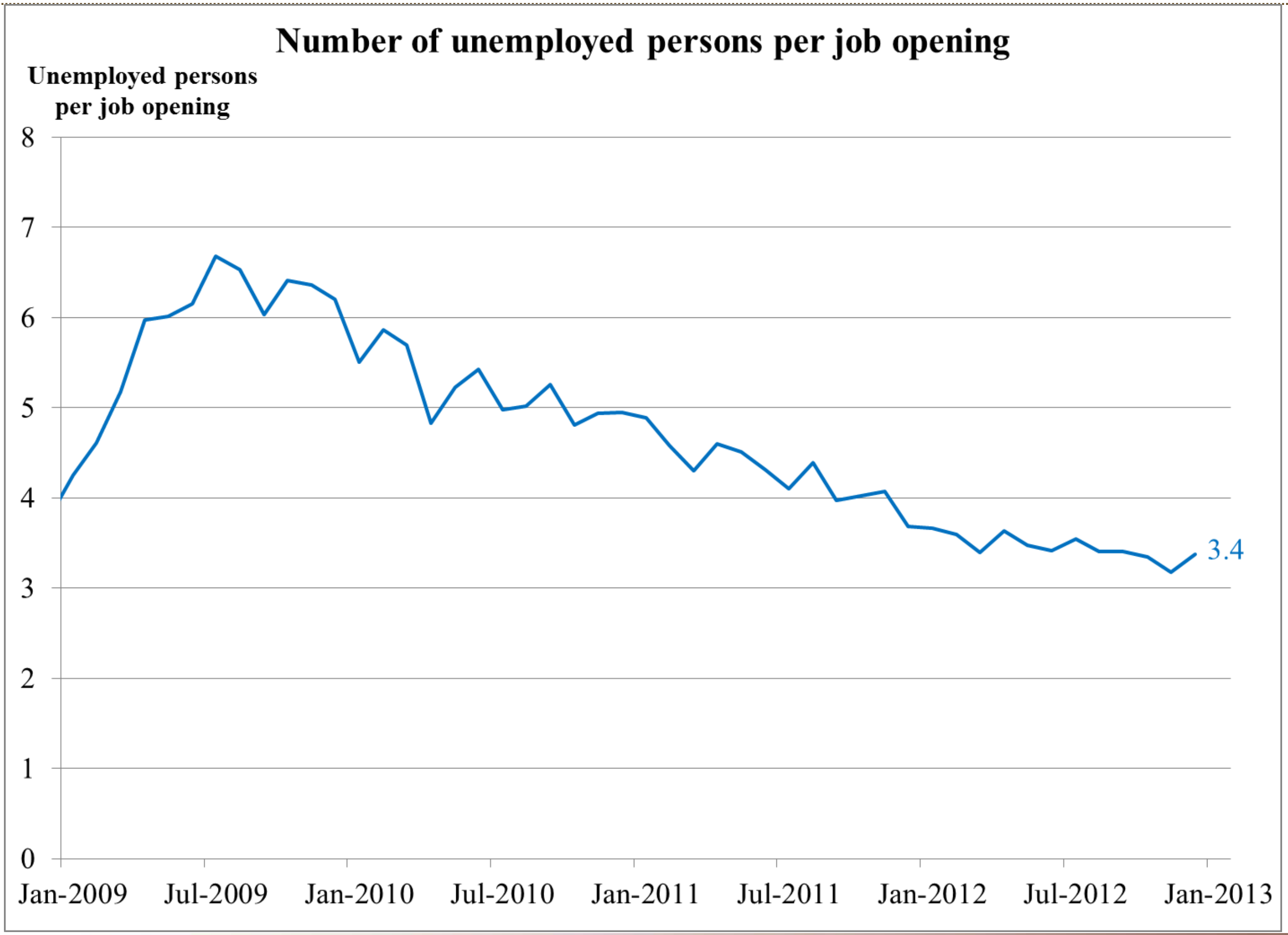
Source: Bureau of Labor Statistics. Last observation: January 2013.

Index of total hours worked



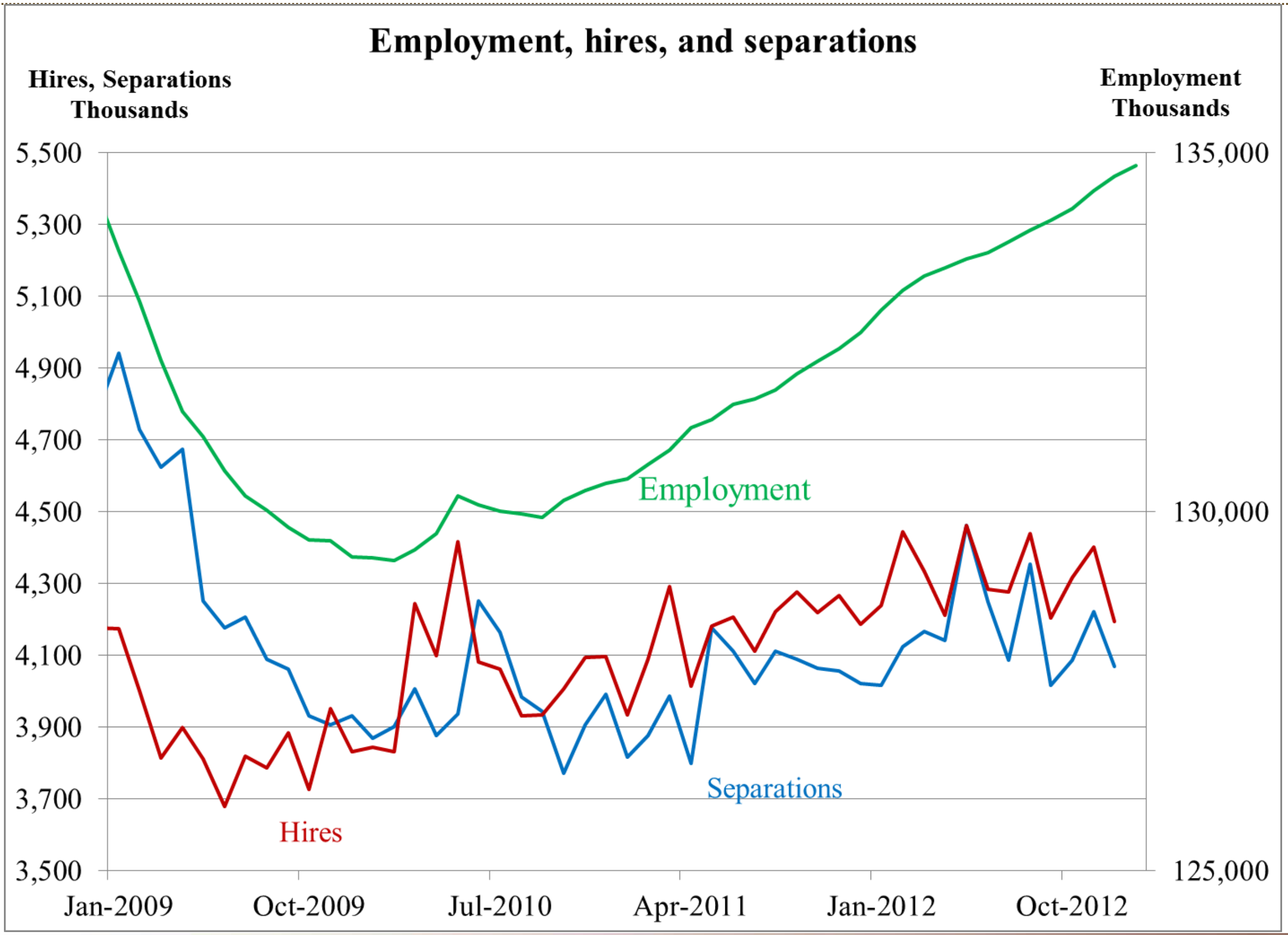
Source: Bureau of Labor Statistics. Last observation: January 2013.

Labor market tightness



Source: Bureau of Labor Statistics. Last observation: December 2012.

JOLTS



Source: Bureau of Labor Statistics. Last observation: January 2013, December 2012.

Altering the Pace of Purchases

Altering the pace of purchases

- "Substantial labor market improvement" does not arrive suddenly.

- This suggests that as labor markets improve somewhat, the pace of asset purchases could be reduced somewhat, but not ended altogether.

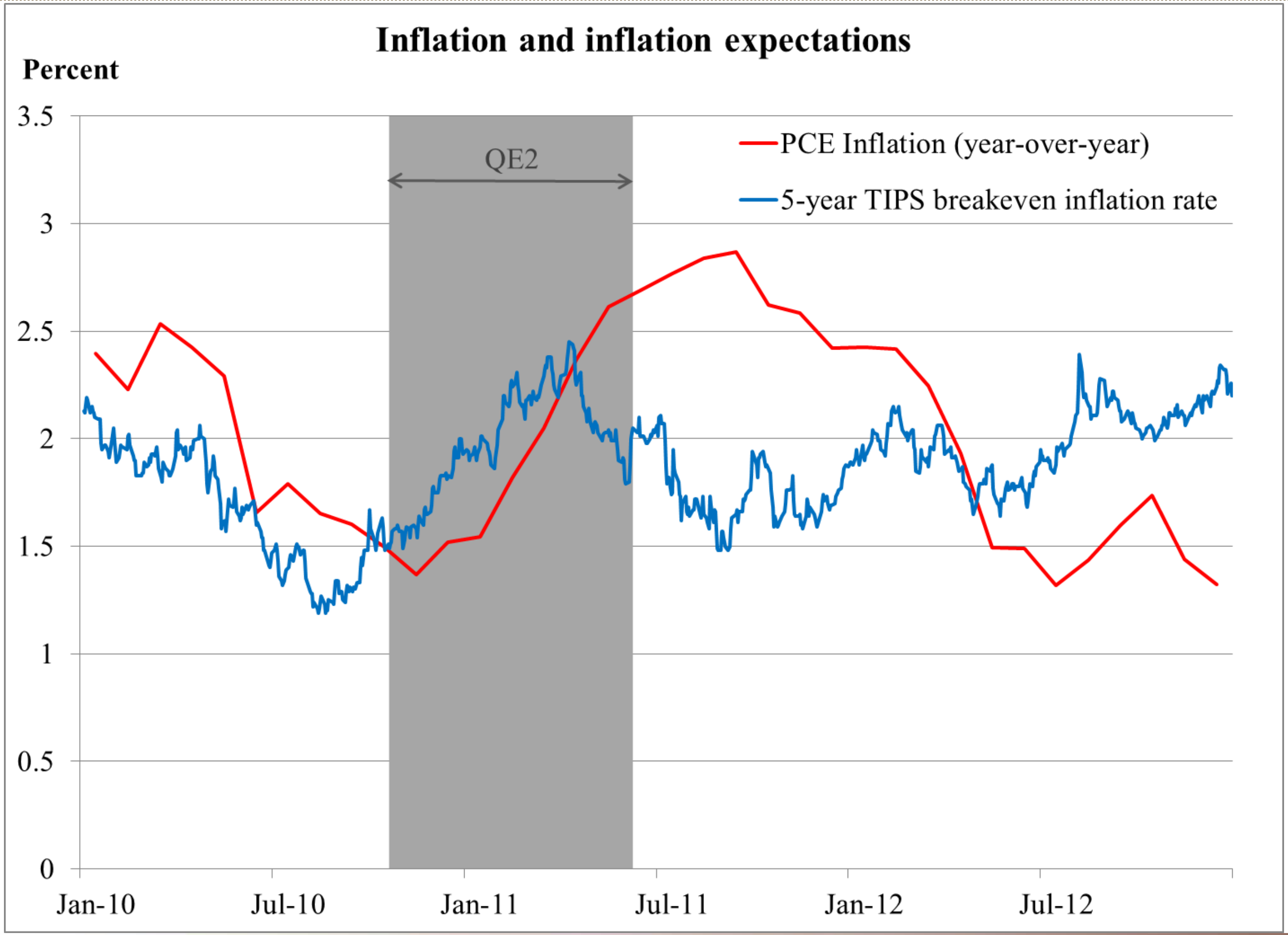
- This type of policy would send important signals to the private sector concerning the Committee's judgment on the amount of progress made to that point.

Inflation and Inflation Expectations

Inflation and inflation expectations

- Current readings on inflation are rather low.
- This may give the Committee some leeway to continue purchases longer than otherwise.
- The lesson from QE2 is that inflation and inflation expectations did trend higher.
  - It is too early to know if that will happen this time.

Inflation and inflation expectations



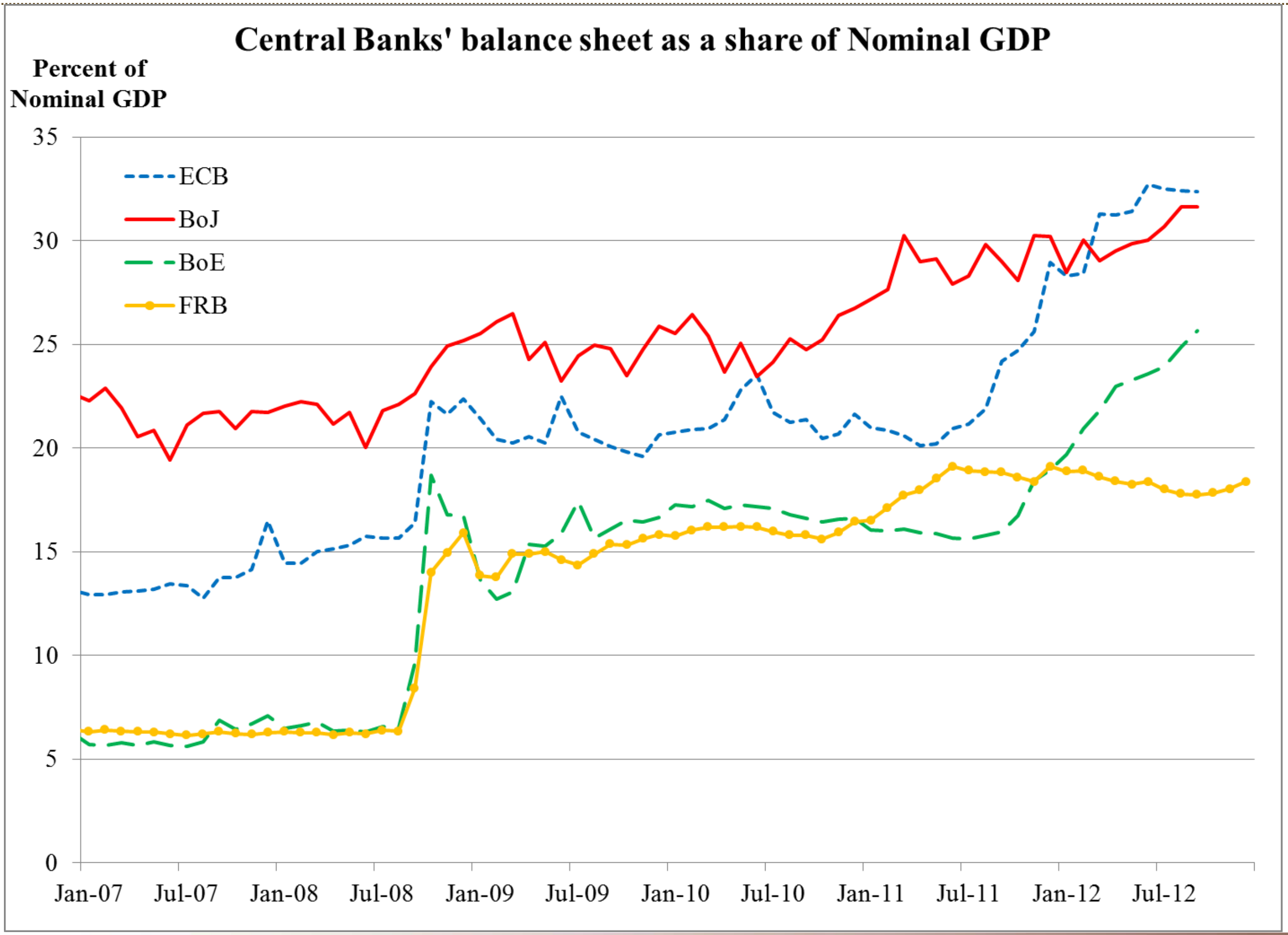
Source: Bureau of Economic Analysis, Federal Reserve Board. Last observation: December 2012, February 12, 2013.

Size of the Balance Sheet

Size of the balance sheet

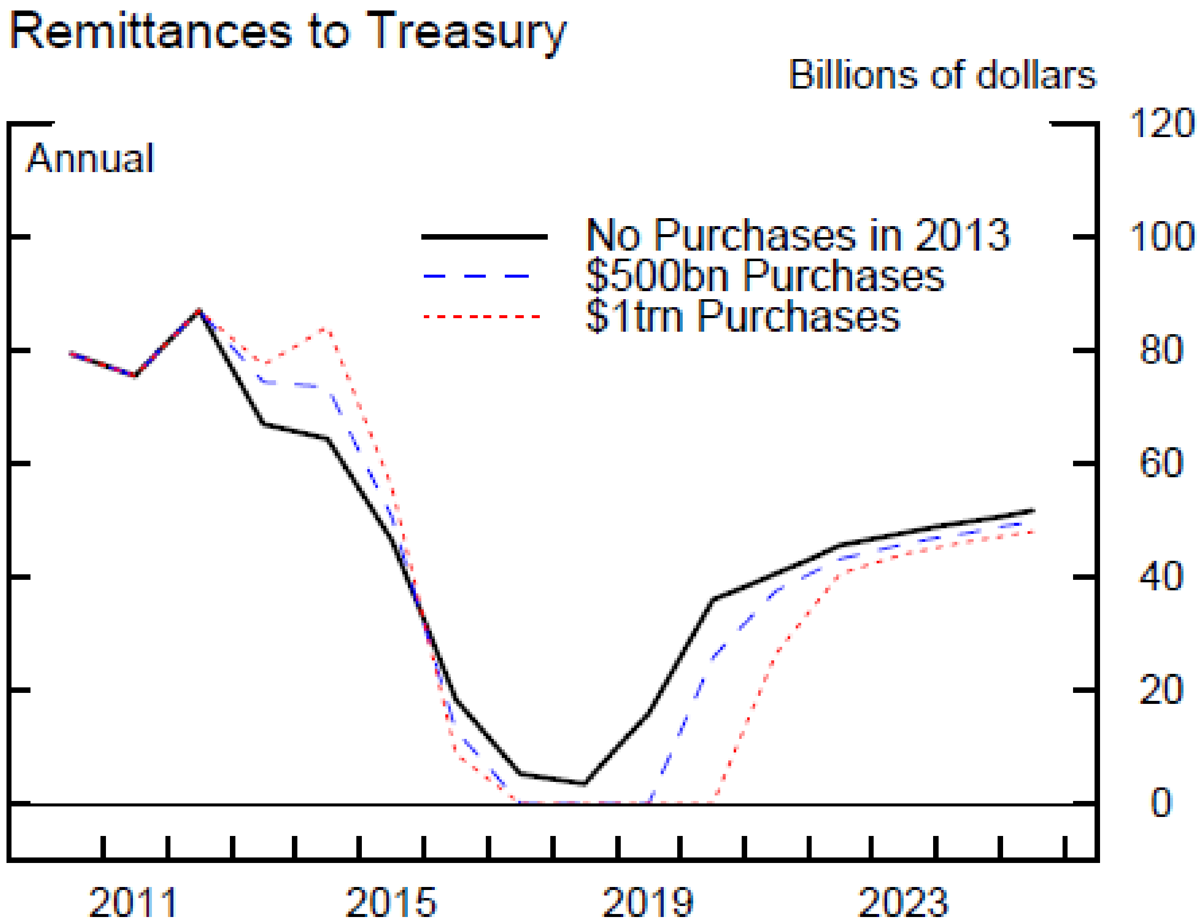
- The size of the balance sheet could inhibit the Committee's ability to exit appropriately from the current very expansive monetary policy.
- The Fed's balance sheet relative to GDP is not as large as some other key central banks.
- However, when interest rates rise, asset values will fall, possibly complicating monetary policy decisions.

Fed balance sheet relative to GDP



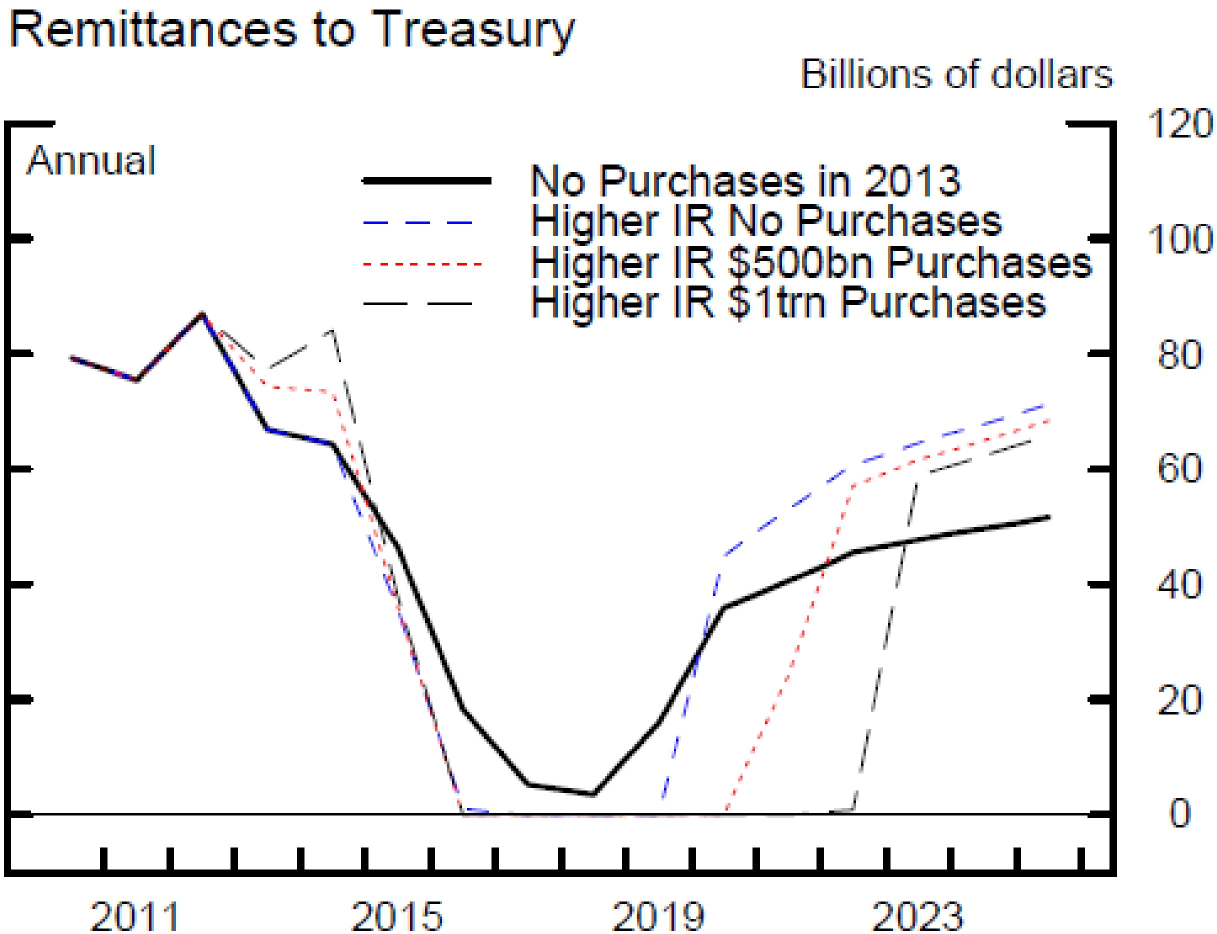
Source: Haver Analytics and author's calculations. Last observation: December 2012 (FRB), September 2012 (others).

Balance sheet size: Complications?



Source: *Carpenter et al., 2013*, "The Federal Reserve's Balance Sheet and Earnings: A Primer and projections," *FEDS Working Paper No. 2013-01*

Balance sheet size: Complications?



Source: *Carpenter et al., 2013*, "The Federal Reserve's Balance Sheet and Earnings: A Primer and projections," *FEDS Working Paper No. 2013-01*

Conclusions

Summary

- The stance of U.S. monetary policy may be considerably easier today than it was during 2012.
  - The nature of forward guidance has improved.
  - The open-ended asset purchase program is more potent than previous programs.
- Considerations for the future of the QE program are multi-faceted and will require a careful judgment of the Committee in the coming quarters.

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Federal Reserve Economic Data (FRED)
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James Bullard
research.stlouisfed.org/econ/bullard/