The Tapering Debate: Data and Tools

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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

Current monetary policy

- Current U.S. monetary policy has two components:
  - A short-term policy rate, which has been near zero since December 2008, and associated forward guidance for that policy rate.
  - An asset purchase program, with current purchases at a pace of $85 billion per month, divided between mortgage-backed securities and Treasuries.

- "Tapering" refers to reducing the pace of purchases in the asset purchase program.

The recent FOMC decision

- The FOMC met on October 29th and 30th.
- The Committee made no changes to the pace of purchases at this meeting.
- Chairman Bernanke has made it clear that future decisions on the pace of asset purchases are data dependent.
- This is in keeping with the strategy laid out by the Committee in September 2012 to pursue an open-ended QE program.

This talk

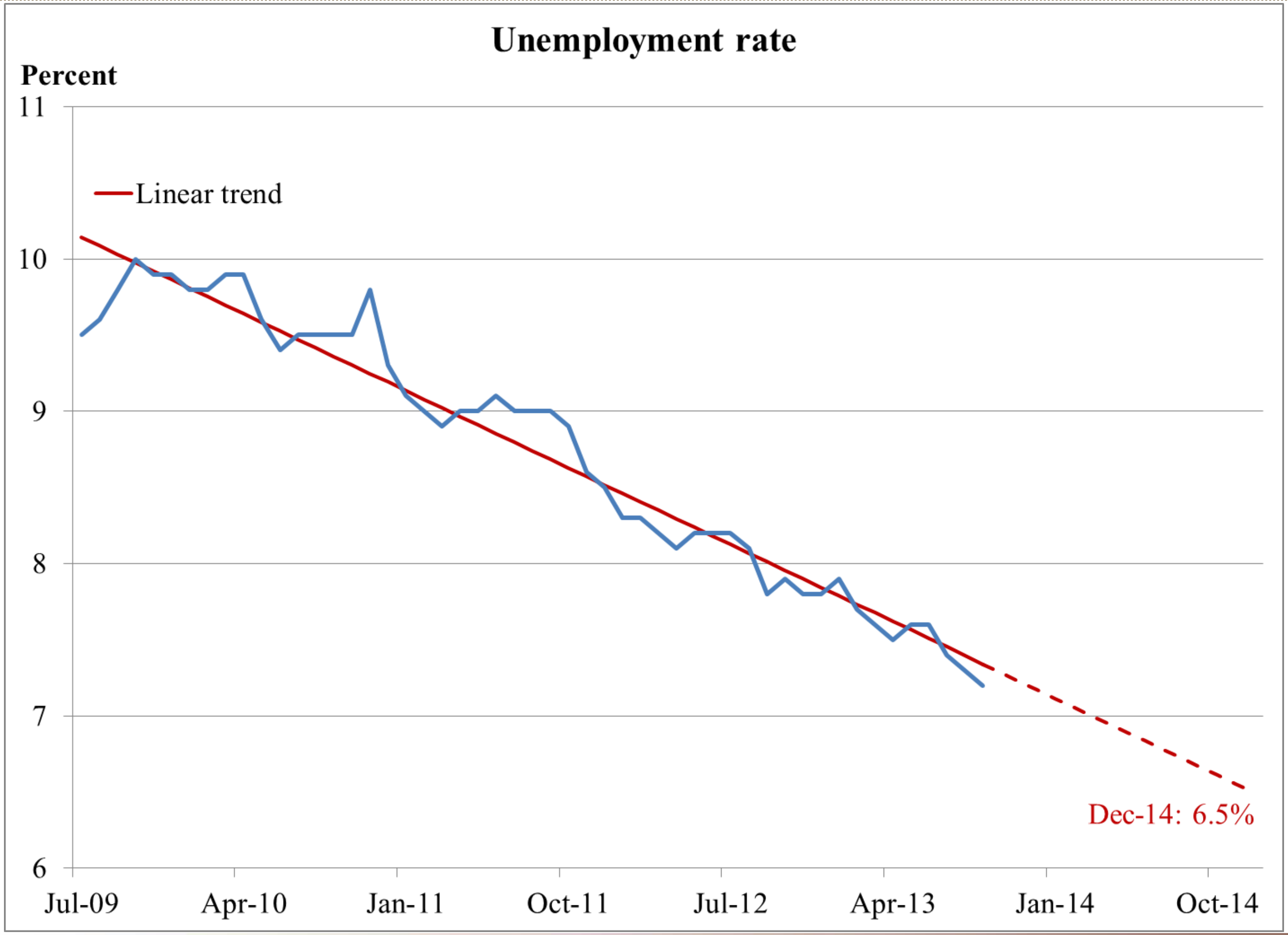
- I plan to talk about two aspects of current policy:
  - Data dependency: Cumulative improvement since September 2012 coupled with sustainability of that improvement.
  - Two different tools: A decision to modestly reduce the pace of asset purchases can still leave a very accommodative policy in place to the extent forward guidance remains intact.

It Depends on the Data

Cumulative progress in labor markets

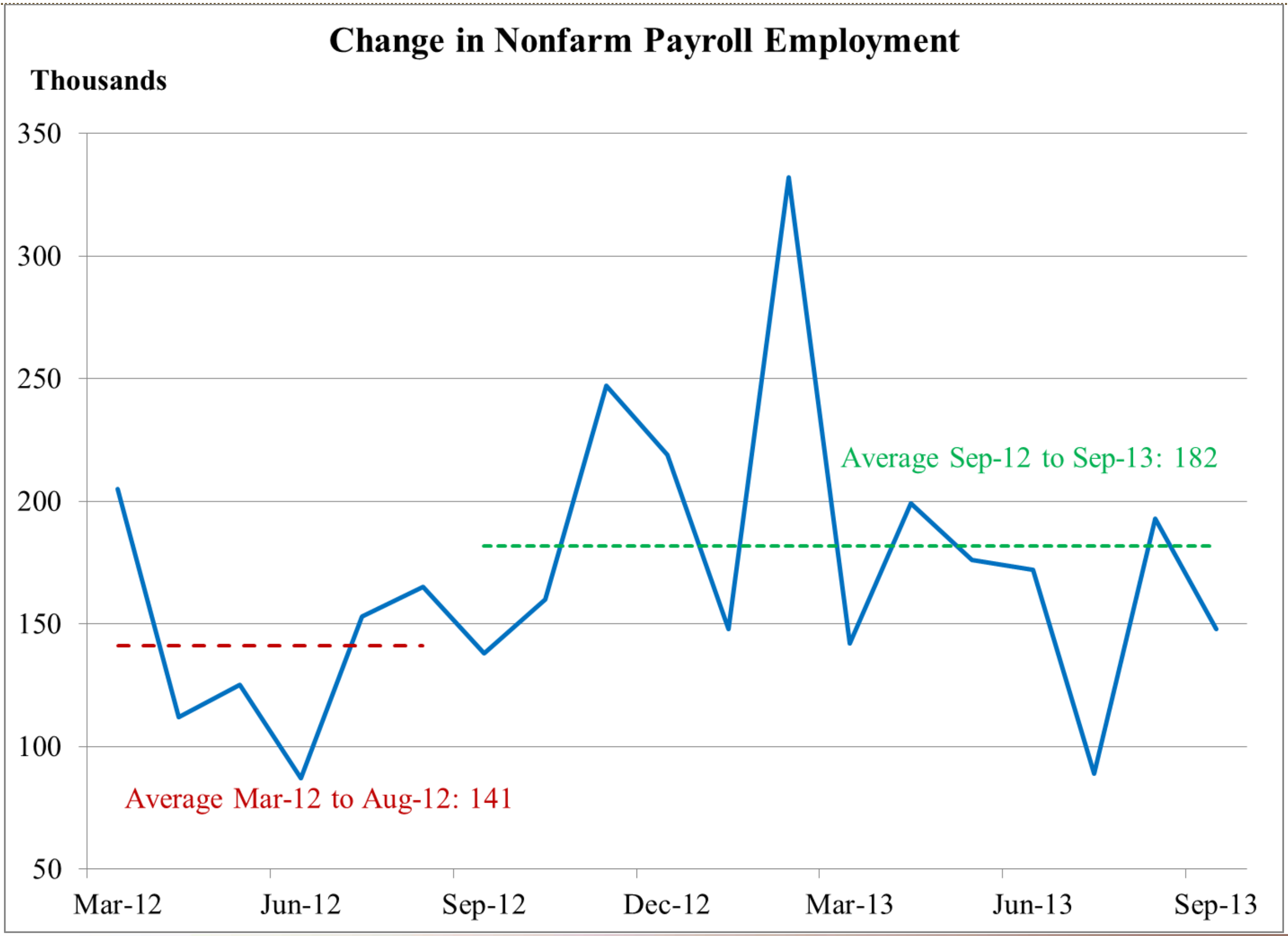
- Does cumulative progress in labor market outcomes since September 2012 matter for QE tapering?
- Yes, and this provides the most powerful part of the case for tapering.
- When the Committee started the QE program in September 2012, the stated goal was substantial improvement in labor market outcomes.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

Unemployment rate



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

Nonfarm payroll employment



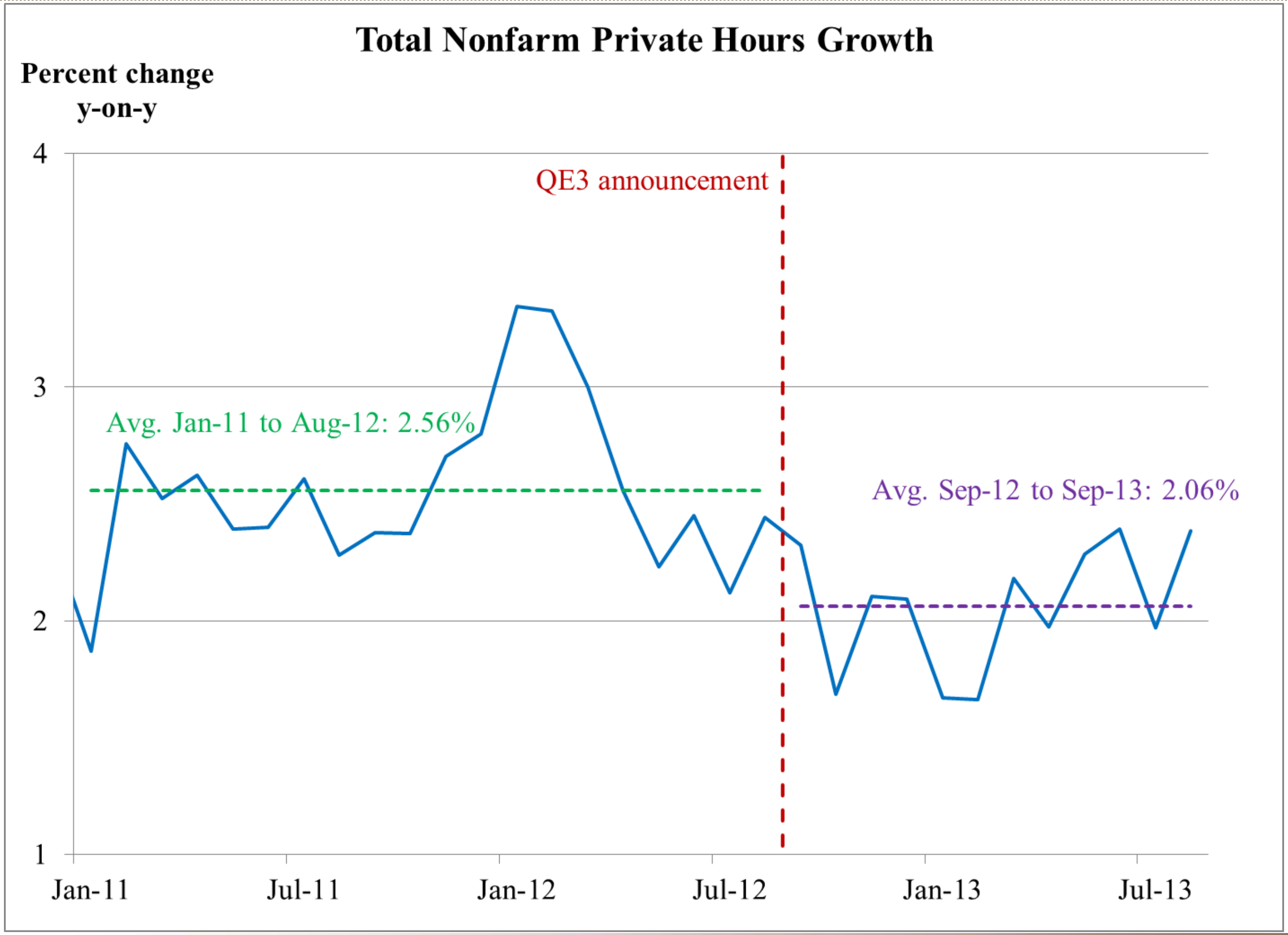
Source: Bureau of Labor Statistics. Last observation: September 2013.

Mixed data

- While the two most important labor market indicators show clear improvement, not all aspects of labor markets have improved.

- As one example, growth in total hours worked has been slower than before the September 2012 decision.

Growth in total nonfarm private hours

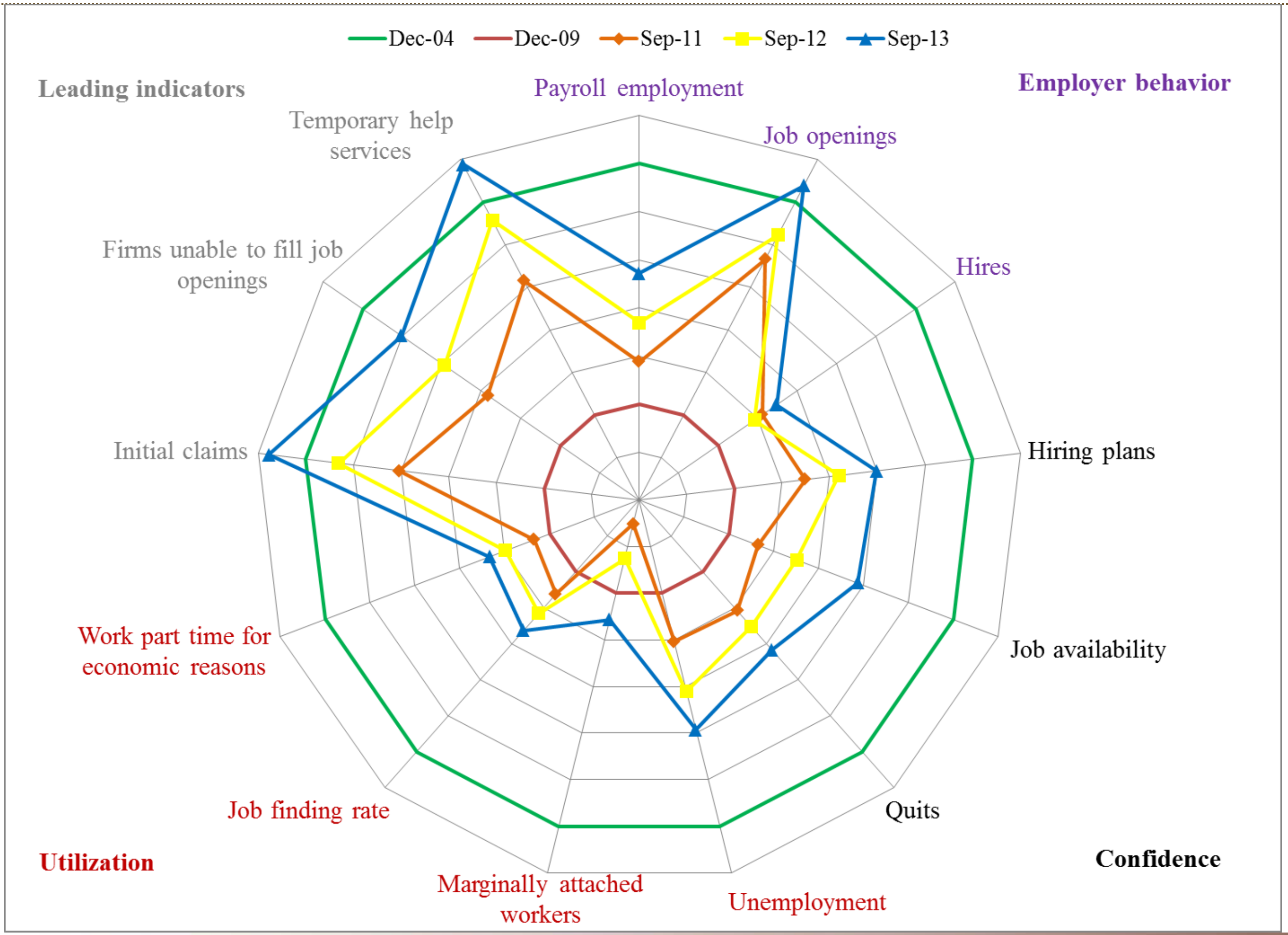


Source: Bureau of Labor Statistics. Last observation: September 2013.

Spider webs

- One way to look at a wide variety of labor market indicators on a single chart is to use a “Halloweenish” spider web chart.
- But even a spider web chart suggests that labor markets have clearly improved since September 2012.

Improvement on all dimensions since 2012



Source: *Bureau of Labor Statistics, Conference Board, National Federation of Independent Business, and author's calculations. Last observation: September 2013.*

Conclusion on cumulative progress

- To the extent that key labor market indicators continue to show cumulative improvement, the likelihood of tapering asset purchases will continue to rise.

- This is because the Committee's 2012 criterion of substantial improvement in labor markets gets easier and easier to satisfy on a cumulative basis as labor markets continue to heal.

Sustainability

- Still, one might worry that while labor markets have indeed improved substantially since September 2012, the progress may not be sustainable and labor markets may slip back in coming months or quarters.
- For this reason, the Committee also wants reassurance that any progress made in labor markets will stick.

Two Monetary Policy Tools

Multiple tools in use

- As I noted at the outset, the Committee has two monetary policy tools in use:
  - A near-zero policy rate coupled with forward guidance on that rate.
  - The asset purchase program.
- Policymakers tend to think of these tools separately.
- Financial markets tend to think of the two tools together.
- Who is right?
  - Both views have some merit.

Multiple tools in use

- The financial market view has some merit because for both tools, the setting is dependent on the state of the economy.
  - When there is a change to the macroeconomic outlook, it is reasonable to think that the settings for both tools would be affected.
- The policymaker view also has some merit, because the two tools can be thought of as independent.
  - The policymaker can choose to respond to a change in the outlook by altering the setting of one tool, leaving the other unchanged.
  - In particular, a decision to taper need not change the Committee's forward guidance.

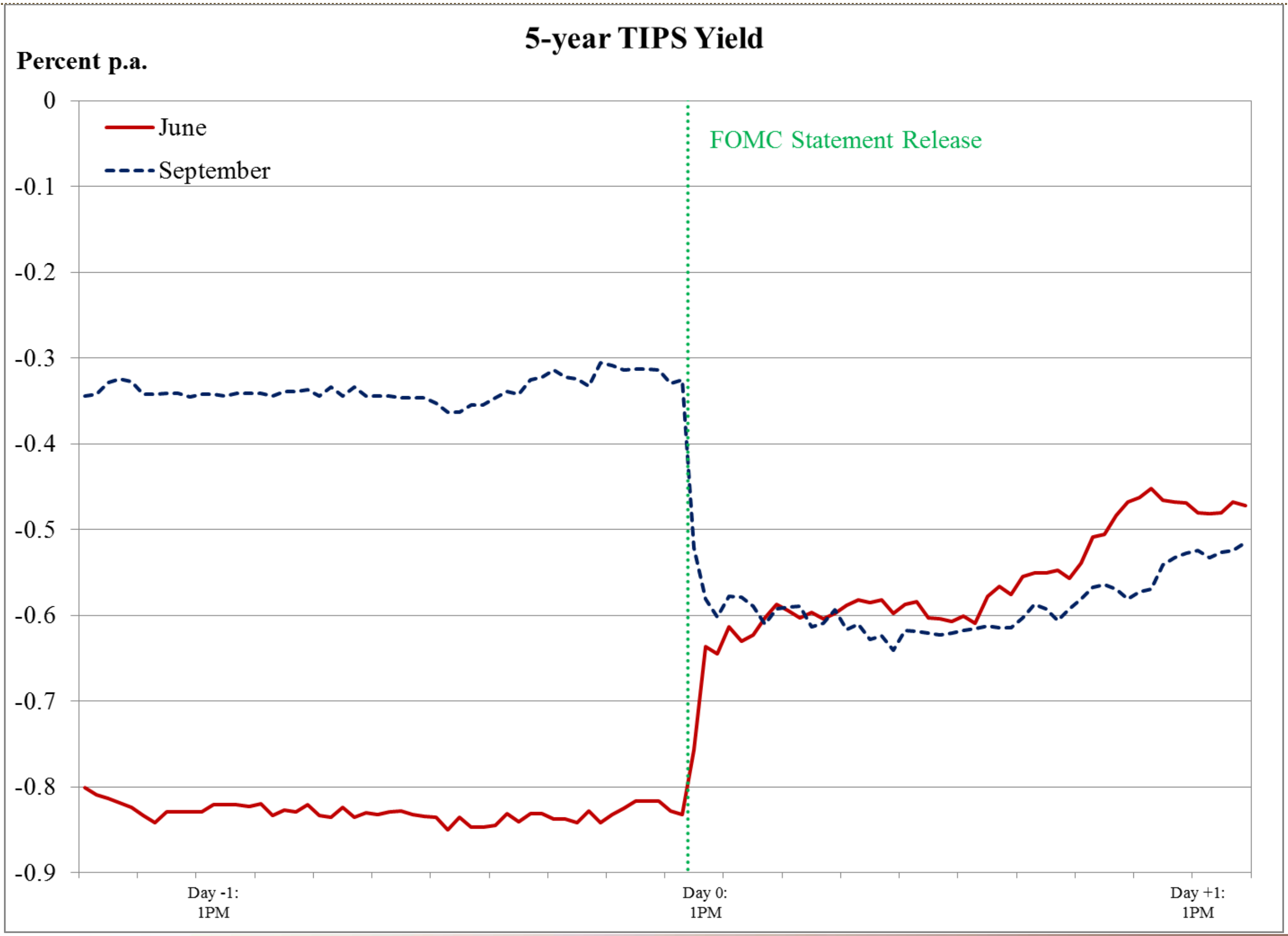
Two views in action

- The Committee announced in June a "roadmap" for a possible tapering decision in the autumn.
  - This announcement was viewed as relatively hawkish by financial markets.
- In September, the Committee decided not to taper at that particular meeting and instead decided to continue with the current pace of purchases.
  - This announcement was viewed as relatively dovish by financial markets.
- These two events provide a window on the connection between asset purchases and forward guidance.

Asset purchases: very effective

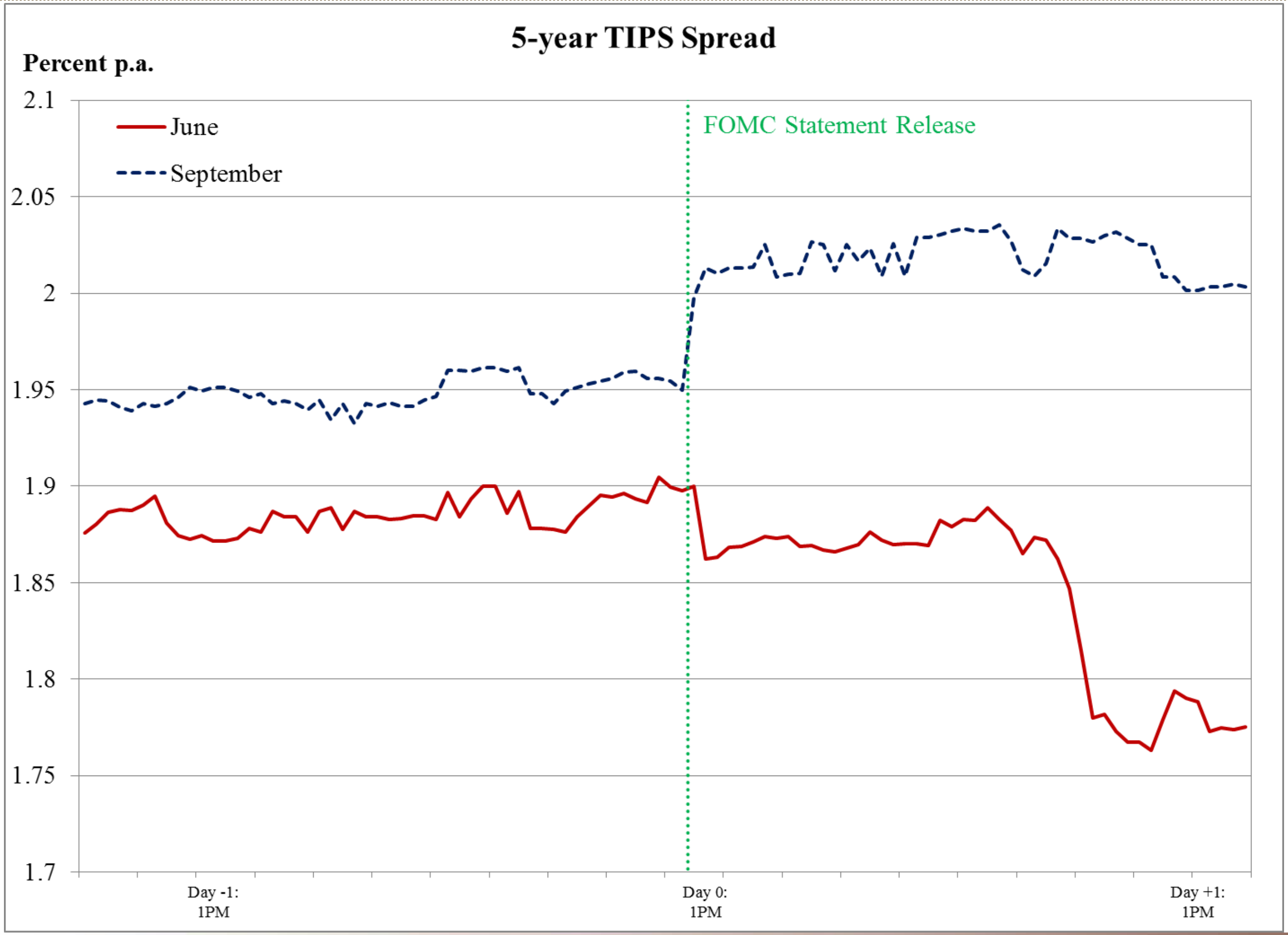
- The “financial markets signature” from the unexpected changes in the policy stance at the June and September FOMC meetings showed that asset purchases are very effective.
- Key variables, including the real interest rate, the exchange rate, equity prices, and expected inflation, moved significantly and in the conventional direction following these announcements.
- This demonstrates that changes in the pace of asset purchases have a very similar financial market effect as changes in the policy rate during more “normal times.”
- The following charts show the response of key variables to the policy announcement in June and September.

Real interest rate



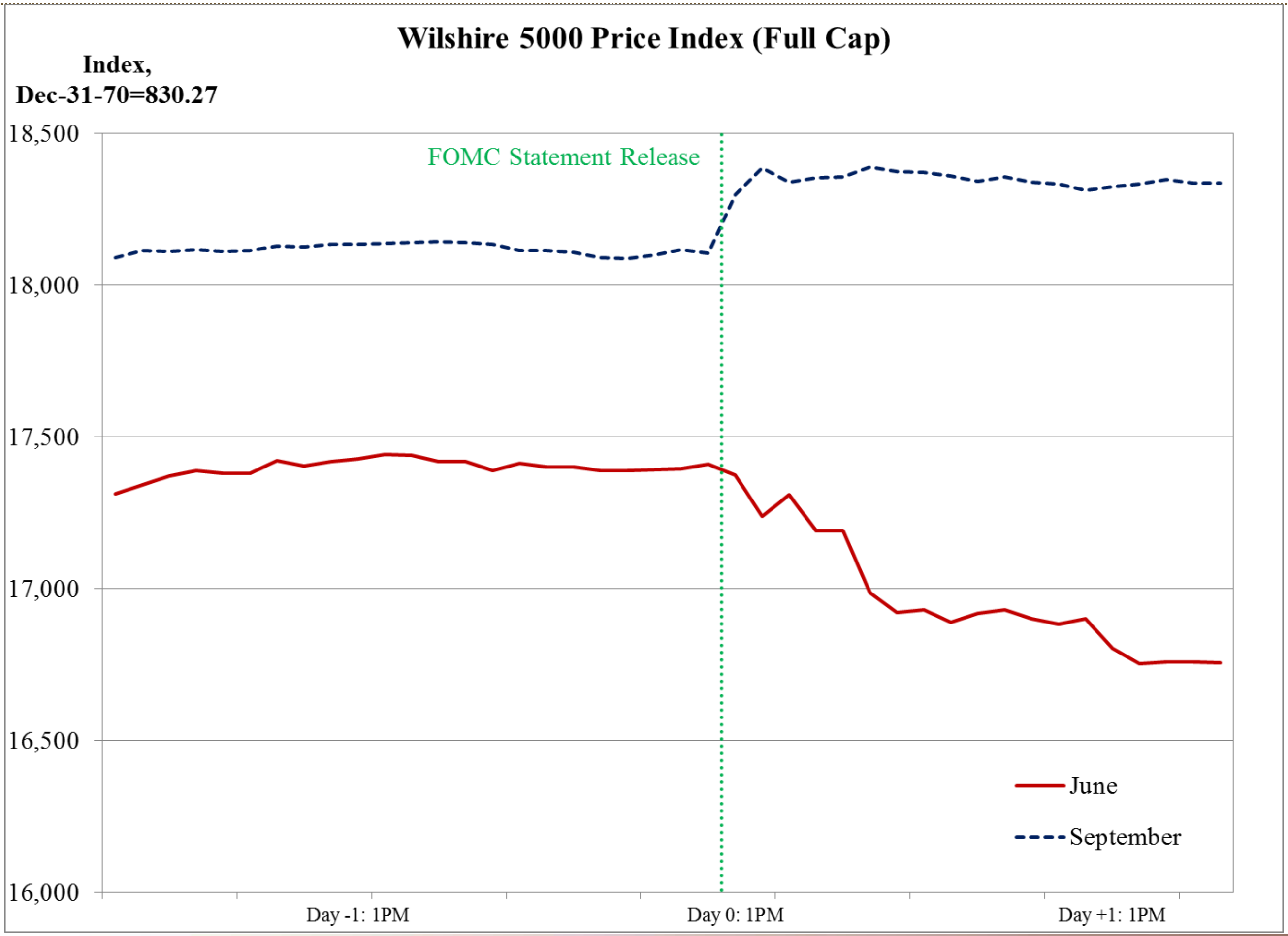
Source: Bloomberg. Last observation: 3:30pm September 19, 2013.

Expected inflation



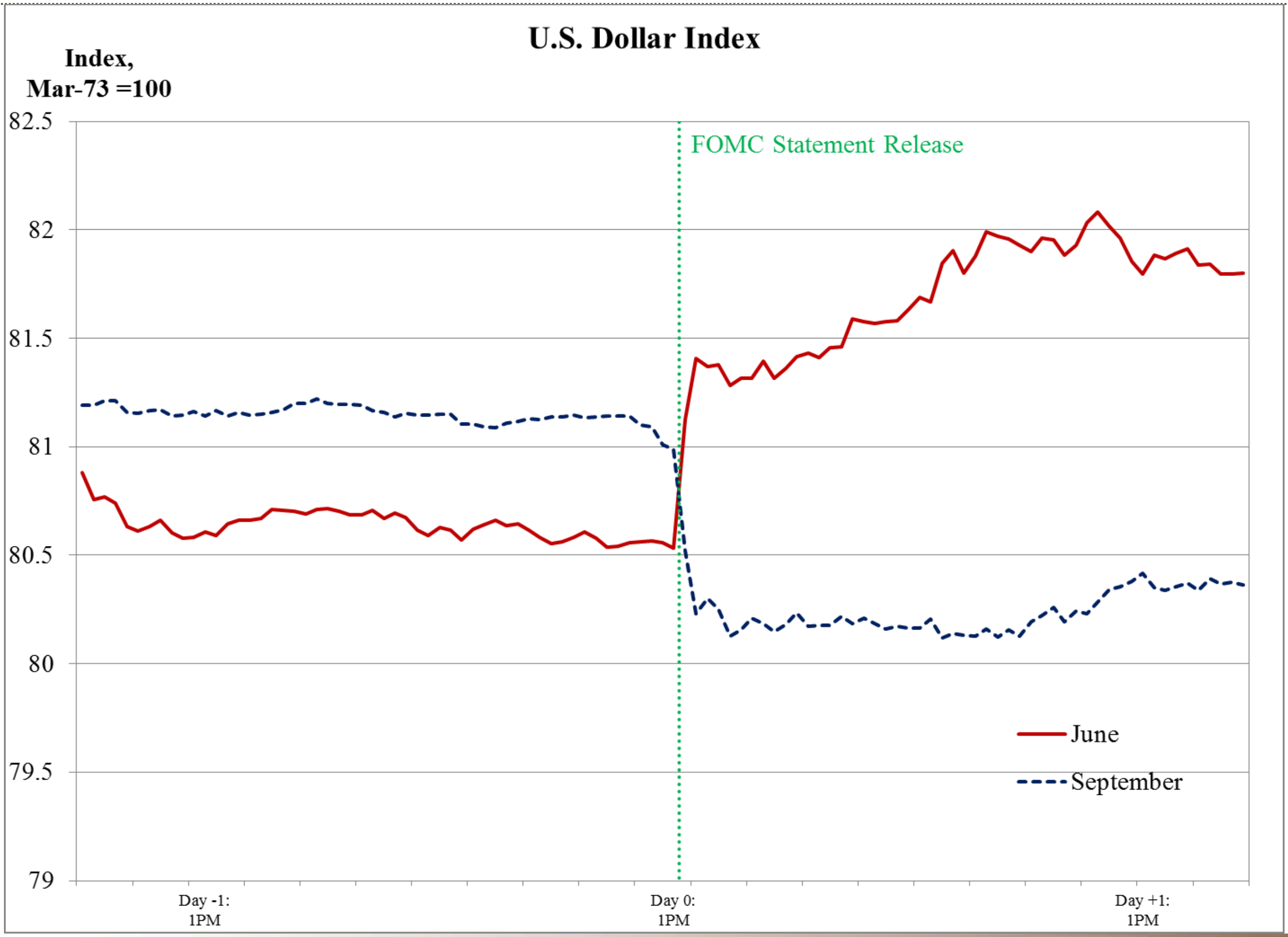
Source: Bloomberg. Last observation: 3:30pm September 19, 2013.

Equity prices



Source: Bloomberg. Last observation: 3pm September 19, 2013.

Exchange rate



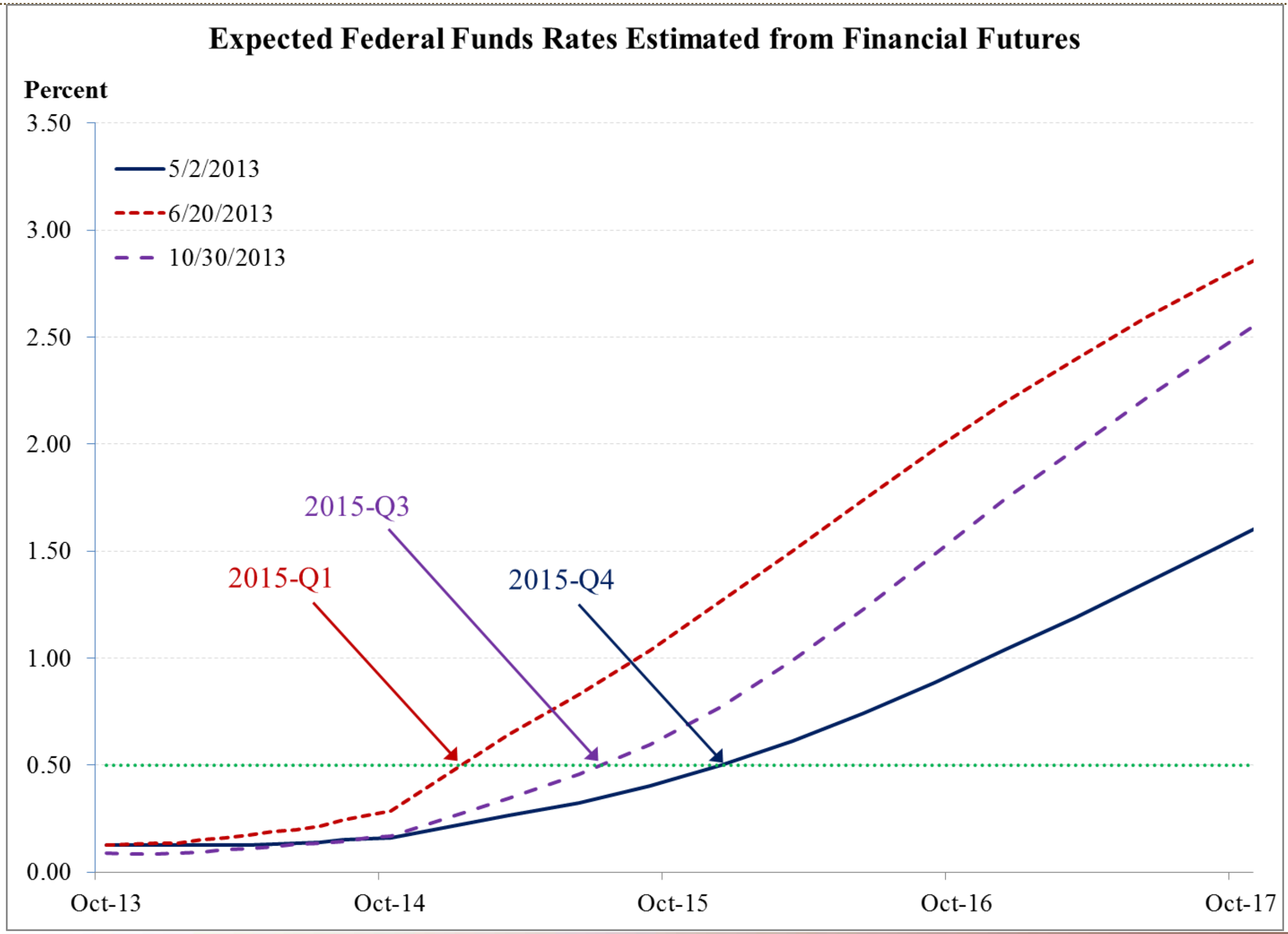
Source: Bloomberg. Last observation: 4pm September 19, 2013.

There was also spillover to forward guidance

- While changing the pace of asset purchases acts very much like a conventional change in interest rates, this effect also spilled over to the expected path of the policy rate, the Committee's "forward guidance."

- This effect was perhaps surprising in the view of policymakers, who view the two tools as independent, but not in the view of financial markets, which view the two tools as tied closely together.

The expected policy rate path



Source: author's calculations. Last observation: October 30, 2013.

Which view?

- In June and September, changes in perceived tapering scenarios led to large movements in key financial market variables.
- The perception of the expected path of the policy rate also changed sharply in response to these events—that is, tapering was clearly linked to forward guidance.
- The Committee needs to either:
  - Convince markets that the two tools are separate, or
  - learn to live with the joint effects of tapering on both the pace of asset purchases and the perception of future policy rates.

Conclusion

Summary

- Any FOMC decision on tapering is data dependent.
  - Data dependence encompasses both cumulative progress in labor markets since September 2012 and a judgment concerning the sustainability of that progress.
- The Committee is using two different policy tools—asset purchases and forward guidance—which it views as independent, but which are viewed as closely linked by financial markets.
  - This presents challenges for the Committee.

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