



FEDERAL RESERVE BANK OF ST. LOUIS

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EXIT STRATEGIES FOR THE FEDERAL RESERVE

This is a speech about exit strategies. It is just talking about exit strategies—the Federal Reserve has thought extensively about this. There has been a lot of tremendous work by the staff at the Board and around the system on these issues. I think the first thing is that the Fed is thinking hard about these issues. The second thing is that for the liquidity programs, I think there is a clear exit mode, and I think that these programs—if financial markets continue to improve—we will probably see these programs sort of tapering off and eventually being discontinued. So, for those, there is a very clear sort of exit scenario. For the asset purchase program, I think it is not as clear, and probably the best option is just to plan to sell some of the assets when the time comes, but that will put upward pressure on interest rates. So that is always a controversial element of any monetary policy.

Why think about an exit strategy while policy is accommodative?

Current monetary policy is very accommodative. We've got nominal interest rates which are close to zero; we've got this very aggressive asset purchase program; we've also got these liquidity programs that are in place. So, we're doing a lot to try to mitigate this recession and that's completely appropriate. The inflation is pretty low, and output of course is way down, and unemployment is very high right now. So, I think the first thing to keep in mind is that monetary policy is accommodative right now, and it will remain accommodative for the foreseeable future. When you're talking about exit strategy, it is something about ... the farther out in the medium term—how is the effect going to unwind all of these very large programs in a way that doesn't create a lot of inflation going forward? So, I think that is the chief concern, and you might say, "Well, why worry about this today? We are in a big recession today, so why not just worry about that tomorrow?" But if we get a lot of expectations of inflation out there in the market, then that will push up longer-term nominal interest rates today and could be counterproductive with respect to the economy.

What price threats do we face in the near medium term?

Well, I think, in 2009, one of the main objectives has been to avoid a sort of deflationary trap outcome like the one Japan experienced. And, you know, even today CPI inflation, measured from a year ago, headline CPI inflation, is negative. So, a lot of that is energy prices, but still that is sort of not very common in U.S. postwar experience. So, this is a very low rate of inflation, and there is some risk that expectations of deflation could become entrenched and you'd get stuck in a deflationary trap. So, the idea has been to avoid that during the most difficult period here in 2009, but in doing so we've increased the monetary base dramatically. We're also running very large fiscal deficits; normally those would be considered very inflationary developments; so, we kind of have this medium-term inflation risk even while we have a short-term deflation risk. So, that is sort of the situation that we face.

Have the liquidity facilities been successful?

The liquidity facilities—and that’s kind of an alphabet soup—there are many different programs, but these were all designed to try improve market functioning, especially during last fall, but earlier as well. The idea was that some markets aren’t performing very well; it’s a traditional thing for the central bank to do in a crisis: put a lot of liquidity into the economy and that’s what these programs did. Market functioning has improved some since last fall. It’s not all the way back to pre-crisis levels, but it is certainly better than it has been in recent times; so, we take that as an encouraging sign.

How can the liquidity programs be unwound?

These liquidity programs I think should be thought of separately from the asset purchase program that is also affecting the Federal Reserve balance sheet. Both of those are affecting the Federal Reserve balance sheet, but the liquidity programs are conceptually different. As I said, a traditional thing to do is, when you are in a panic or you are in a crisis, the Fed will flood the market with lots of liquidity. That’s what those programs, those liquidity programs, are doing. But they are much easier to unwind than the asset purchase program, so they naturally run off as the crisis subsides. That is what happening now with our Term Auction Facility and with our foreign currency swaps with foreign central banks and with our commercial paper funding facility. All of those are sort of winding down, and I think part of the thinking was that we could let those continue to naturally wind down over the remainder of this year and maybe into next year. Keep the programs in place, maybe without even any activity going on in the programs, but keep them in place because you never know if financial turmoil will return. But these liquidity facilities will sort of naturally come down to zero. Then, that part of the increase in the monetary base that’s associated with that program, that will all come back. So, that’s helpful from the point of view of our medium-term inflation threat.

Will the asset purchase program lead to inflation?

The asset purchase program is fairly large numbers we’ve committed to purchase up to \$200 billion of agency debt—that means Fannie Mae and Freddie Mac. Up to \$1.25 trillion in agency mortgage-backed securities and up to \$300 billion in longer dated treasuries; so, that’s a total of \$1.75 trillion—that’s a lot of money even at the Federal Reserve. All of that is being financed really by just reserve creation at the Federal Reserve; so, this increasing the monetary base dramatically. If you permanently double the money supply, you will eventually double the price level. So it might take some time, and the money supply would go up—stay up at this higher level—and the price level would follow behind. If it took ten years, that would be seven percent a year for inflation over a ten-year time period. So, that’s just to get rough numbers about the kind of threat that we are thinking about over the medium term, medium to longer term. That kind of puts it into perspective. Now there are reasons to think that that kind of inflation will not develop. There is going to be a lot of slack in the economy for several years here. Is the increase in the monetary base really permanent, the way it would be in your classroom exercise? Well, maybe not, some that will run off over time. So these are all issues that we have to think about when we are trying to assess the situation, but it is a point of concern, and, again, if expectations of inflation get started today that will enter into longer term yields today and could be counterproductive for recovery.

Are there other financing alternatives for large asset purchases than reserve creation?

We have this very large asset purchase program, and, really, what we are doing to purchase all of the assets is we're creating reserves; so, that's sort of printing money in a way, and that's what's leading to the big increase in the monetary base. There are alternatives; there are other ways you could do this. One way is that, instead of creating the reserves, you would have the Treasury issue some debt and put the proceeds on deposit at the Federal Reserve. That would be an alternative financing method to do the same thing, and then you wouldn't be increasing the monetary base if you did it that way. Given the big fiscal deficits, though, and the debt ceiling—the debt ceiling requires a vote of the Congress—it doesn't really look like the Treasury has much scope to do something like that in the current circumstances. You could also have the central bank issue its own debt, which sounds radical from the U.S. perspective but is actually done by some foreign central banks. That would require an act of Congress to get that authority, and it is not too clear that Congress would be willing to allow the central bank to issue debt outside of the debt ceiling, which is established by the Congress. So, it doesn't really look like those are viable options right now, partly because of the fiscal situation in Washington; so, that's leaving us with reserve creation as the way to purchase these assets. That's what's leading to the run-up in the monetary base and that's what's leading to the medium-term inflation risk.