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Some Issues in Current U.S. Monetary Policy

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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 September 2012 strategy

- The strategy laid out by the Committee in September 2012 was to pursue an “open-ended” asset purchase program.
- Chairman Bernanke has made it clear that future decisions concerning the pace of asset purchases are data dependent.

This talk

- I plan to talk about several aspects of current monetary policy:
 - Fed communications: Press conferences at every meeting.
 - Data dependency: Cumulative labor market improvement since September 2012 coupled with sustainability of that improvement.
 - Inflation: It has been running low.
 - Possible changes to forward guidance.

Press Conferences

Fed communication

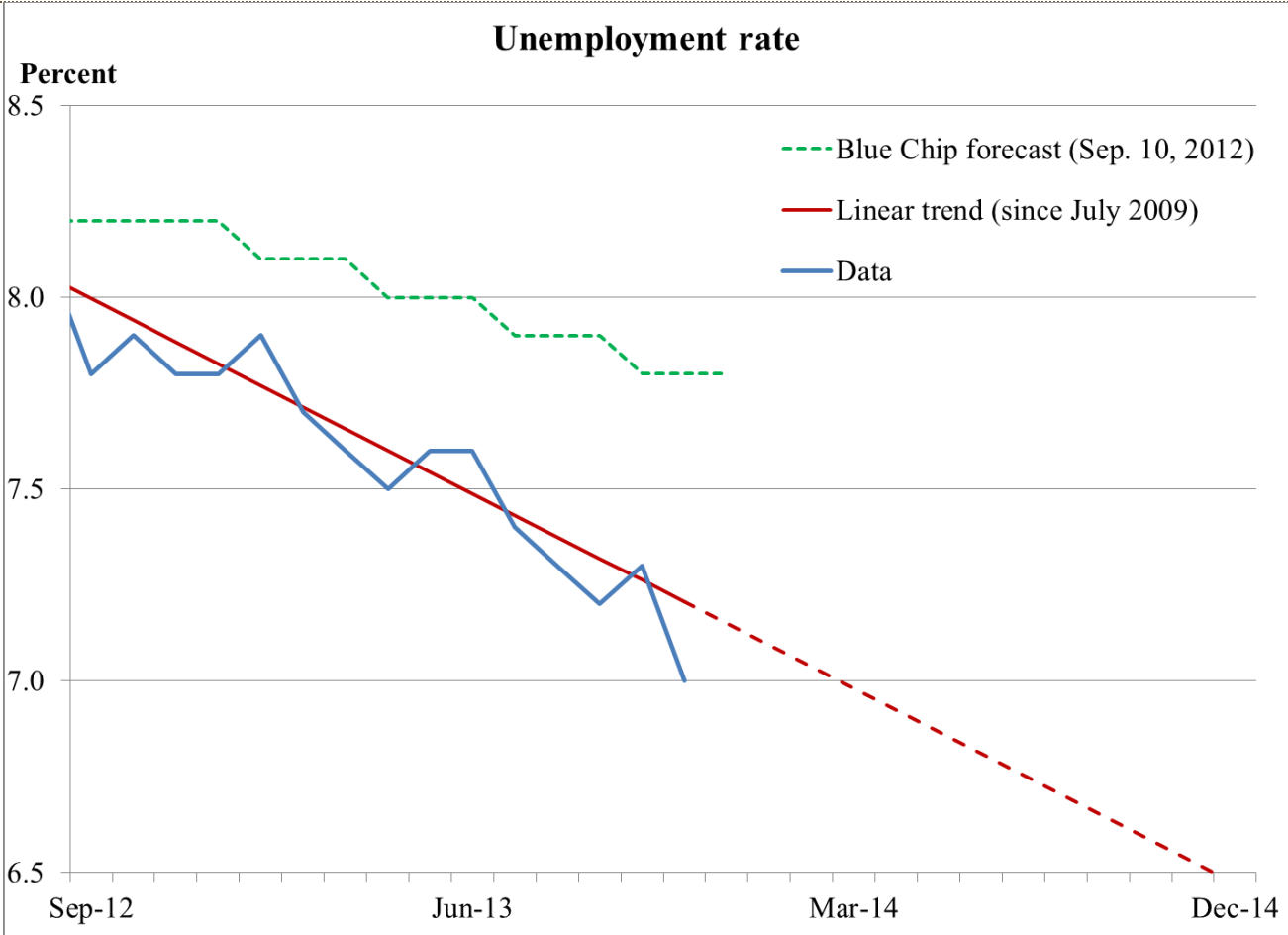
- The Chairman gives a press conference after some meetings but not others.
- Markets have suggested that meetings without press conferences are unlikely to be situations where the Committee can take important action.
- The FOMC needs to keep its options open.
- One way to do this is to include a press conference after every meeting.

Cumulative Progress in Labor Markets

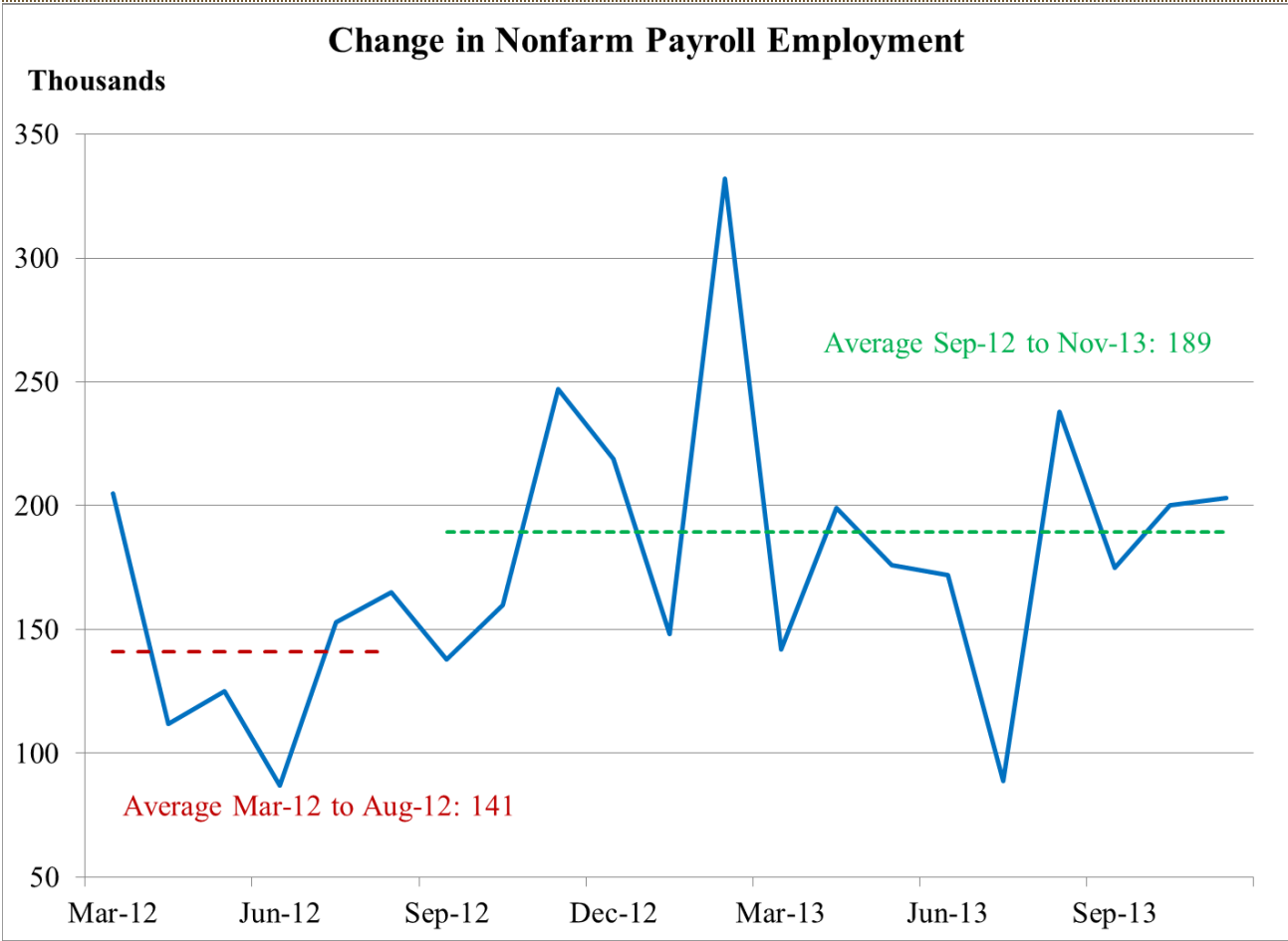
Cumulative progress in labor markets

- 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.
- Cumulative progress in labor market outcomes since September 2012 provides the most powerful part of the case for tapering.

Unemployment rate



Nonfarm payroll employment



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.
- 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

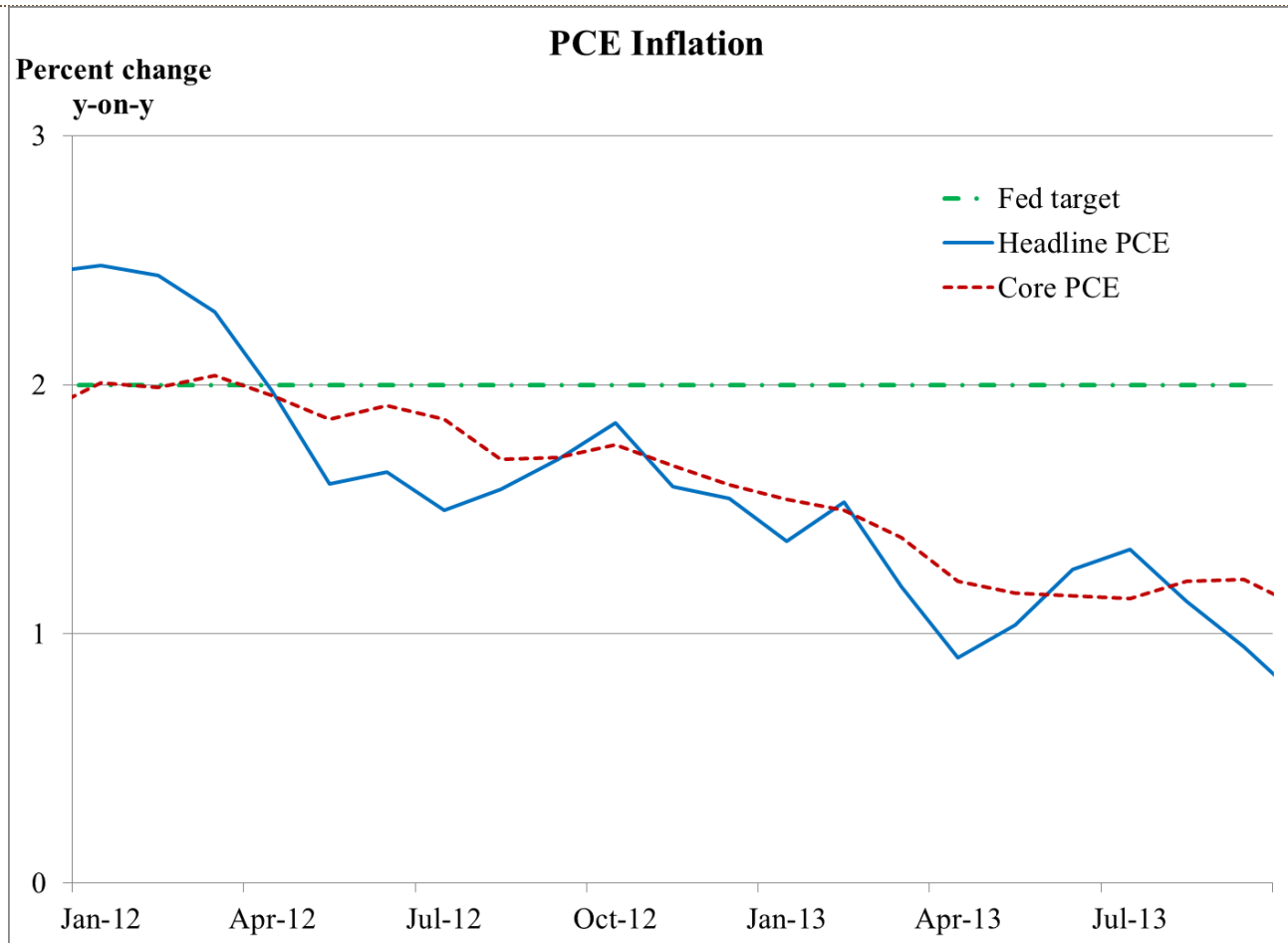
- It is of course possible that the pace of labor market improvement will slow down in coming months or quarters.
- For this reason the Committee also needs to assess whether progress made in labor markets will continue into the future.
- Recent labor market results seem to suggest that coming months will show continued labor market improvement.
- Based on labor market data alone, the probability of a reduction in the pace of asset purchases has increased.

Low Inflation

Inflation remains low

- Many have argued, including me, that the Fed's asset purchase program risks creating substantial inflation in the future.
- Currently, however, inflation remains low.
- There is no widely-accepted reason why inflation is running as low as it is in the face of extraordinarily accommodative policy from the Fed.

Inflation remains low



Approaches to tapering

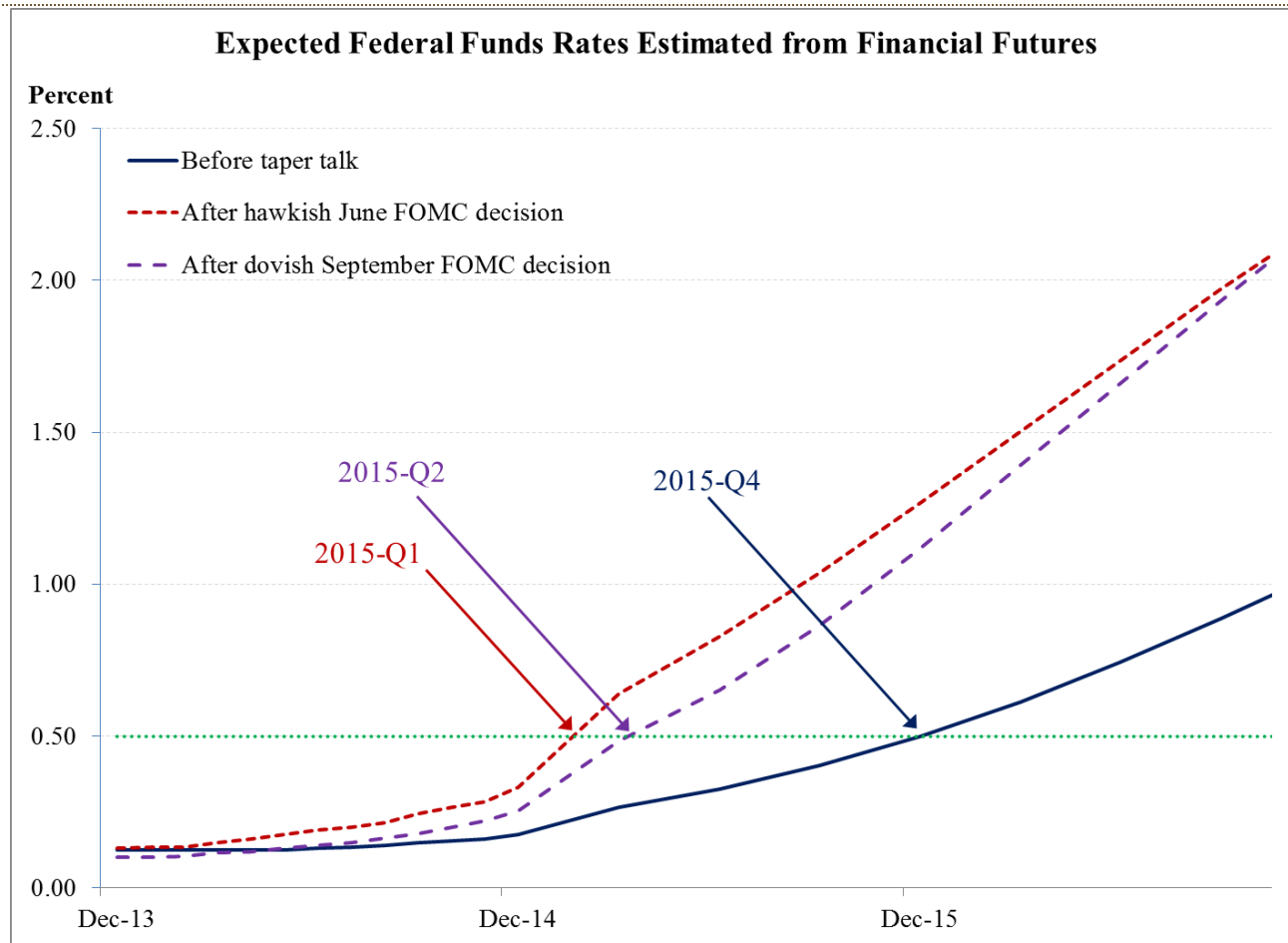
- The asset purchase program was designed to behave like a “booster rocket” for U.S. monetary policy accommodation.
- Labor market outcomes have been considerably better than those predicted at the time of the September 2012 QE3 decision, while inflation has surprised to the downside.
- A small taper might recognize labor market improvement while still providing the Committee the opportunity to carefully monitor inflation during the first half of 2014.
 - Should inflation not return toward target, the Committee could pause tapering at subsequent meetings.

Changes to Forward Guidance

Spillovers from taper talk to forward guidance

- In June and September, changes in perceived tapering scenarios led to large movements in key financial market variables.
- Perhaps surprisingly, 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.

The expected policy rate path responds



Changes to forward guidance?

- To clarify the independence of the asset purchase program from forward guidance, the Committee may consider changes to forward guidance.
- The current guidance states that the Committee will not raise rates so long as unemployment is above 6.5 percent and inflation remains below 2.5 percent.

Three options

- Lower the unemployment threshold?
 - Puts the credibility of the thresholds approach at risk.
 - If the threshold is moved once, could it be moved again?
- Establish an inflation floor at 1.5 percent?
 - Symmetric with the current forward guidance on inflation.
 - Helpful if inflation continues to behave in an unusual manner.
- State verbally that the Committee is unlikely to raise rates even after the 6.5 percent unemployment threshold is crossed?
 - The Chairman has already done this.
 - Less complicated and possibly just as effective.

Conclusion

Summary

- A press conference at every meeting would likely improve Fed communications.
- 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.
 - Inflation continues to surprise to the downside.
- I have listed some possible options for altering forward guidance.



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