Federal Reserve Bank *of* Atlanta

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Just how does policy work?

In the immediate aftermath of the Federal Open Market Committee's November 3 decision to expand its net asset positions with an additional $600 billion in Treasury purchases, a theme emerged among the commentariat: the policy's aim, as the story goes, is to engage in competitive devaluation of the dollar, juicing the economy by prompting greater spending by foreigners via a cheapened greenback.

Earlier this week, Atlanta Fed President Dennis Lockhart provided his perspective:

> "… I don't think it is out of line to state clearly that, as I see it, there is no monetary policy intent to engineer specific values—or even a direction—for the dollar. In other words, this policy was not undertaken to prompt dollar depreciation."

Of course, the value of the dollar against a broad basket of currencies did fall in the aftermath of Chairman Bernanke's comments at the Kansas City Fed's August Economic Policy Symposium and continued to fall through the latest meeting (the decline has reversed somewhat since then). These comments were widely interpreted as a signal of additional asset purchases.

While it is not appropriate for me to comment on what the value of the dollar *should* be, I believe it *is* appropriate to provide some perspective on how we think about dollar depreciation.

In addressing that topic, let me take a brief detour to ruminate on how monetary policy works. In spring 2009, near the end of the worst of the financial crisis, I wrote (in this space) of how I think about "nontraditional" monetary policy (the direct lending facilities created at the height of the crisis and the large-scale asset purchase program that was just under way at that time). The upshot was that I think of nontraditional tools as a way to, as best we can, replicate traditional policy in nontraditional circumstances. I personally believe that remains an appropriate way to think about what the Fed is doing. Chairman Bernanke provided this perspective in his remarks at a European Central Bank conference today.

> "Although securities purchases are a different tool for conducting monetary policy than the more familiar approach of managing the overnight interest rate, the goals and transmission mechanisms are very similar."

So, how is traditional monetary policy implemented? Put simply, the first thing to note is that traditional policy is almost always implemented by open market purchases of assets, Treasury securities in particular. Though traditional policy is described in terms of targets for the federal funds rate, the fact is these targets are simply guides as to how big those open market purchases of securities by the Fed need to be. (The answer is, as big—or small—as necessary to hit the funds rate target chosen by the Federal Open Market Committee.)

But that is just a story about how policy is implemented. How policy *works* might go something like this: The central bank, by creating more short-term liquidity, alters the composition of assets held in private portfolios. Unless that additional short-term liquidity exactly matches an increase in the demand for it, the infusion of "cash" will result in portfolio rebalancing—a shift into other types of assets. The increased demand for those assets, of course, affects their yields.

That logic is a familiar textbook description of the monetary transmission mechanism. It is also, more or less, the description of how the current "nontraditional" asset-purchase policy is supposed to work, as explained by Chairman Bernanke at the aforementioned Kansas City Fed Policy Symposium:

> "I see the evidence as most favorable to the view that such purchases work primarily through the so-called portfolio balance channel, which holds that once short-term interest rates have reached zero, the Federal Reserve's purchases of longer-term securities affect financial conditions by changing the quantity and mix of financial assets held by the public. Specifically, the Fed's strategy relies on the presumption that different financial assets are not perfect substitutes in investors' portfolios, so that changes in the net supply of an asset available to investors affect its yield and those of broadly similar assets."

What constitutes "broadly similar"? Well, one category would certainly be comparable assets denominated in different currencies. Savers operate in global capital markets, so it would not be the least bit surprising if some portfolio rebalancing associated with open market operations found their way to the exchange rate. But that is as true of traditional policy as it is of nontraditional policy. A potential effect on the exchange rate does not make the exchange rate an object of policy, traditional or otherwise. It *does* make the international value of the dollar one of the vast array of asset prices that might be impacted when a monetary policy action is taken.

But if the potential effect fails to materialize, or even moves in what seems to be a contrary direction, does that mean policy is a failure? I believe the answer is no. Markets are complex beasts, and there is no exact formula as to how, when, and where the impacts of monetary actions appear. This uncertainty exists even with traditional policy, for which we now have a fair amount of experience gauging how, for example, choices for federal funds rates feed into the objectives of monetary policy with respect to growth and price stability.

About this time in 2008, I noted that the extended episode of low interest rates in the 2002–2004 period had little discernible effect on long-term interest rates. Does that mean that the policy was ineffective in promoting price stability or growth objectives?

In the end, the proof is about whether policy objectives are being met, and those policy objectives are *not* about the specific value of the exchange rate (or the Dow Jones average, or even the 10-year Treasury rate). On those objectives, President Lockhart had this to say in his speech this week:

> "In regard to price stability, this policy has already shown some signs of success by altering inflation expectations and reducing the risk of unwanted disinflation. To explain, inflation expectations extracted from Treasury inflation-protected securities, or TIPS, spreads over like-duration Treasury securities were declining persistently over the course of late spring through summer. Following the August 27 Jackson Hole speech by Fed Chairman Ben Bernanke, these spreads have recovered to previous levels. In addition, according to analysis we've done at the Atlanta Fed, deflation probabilities reflected in TIPS have fallen from the high levels prior to the September FOMC meeting.
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> "Managing inflation expectations requires following through with policy actions consistent with stated objectives—in this case ensuring that inflation trends remain in a desired zone. The FOMC's November decision should be seen in that light."

And that is a good last word.

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