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Federal Reserve policies focused

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On Nov. 3, the Federal Open Market Committee (FOMC)—the group within the Federal Reserve charged with formulating monetary policy for the United States—announced its plans to purchase, over the course of the next eight months, up to $600 billion worth of longer-term Treasury securities.

In many circles (maybe including yours), this decision has generated some controversy. A good deal of the controversy revolves around the view that this monetary policy decision is aimed at buying up government debt for the purpose of making it easier for the country to continue on the path of deficit spending. This view is inaccurate.

I understand the concerns that are triggered when the Fed announces a significant Treasury purchase program at a time when the fiscal situation is so challenging and unsettled. Be it the hyperinflations of Germany's Weimar Republic in the period between the two world wars; Hungary after World War II; or the more recent case of Zimbabwe, most of us have heard or read of extreme examples of countries that ended up creating big problems trying to finance government by printing money.

Generating government revenues via the printing press is a policy that is often referred to as "monetizing the debt." I think the emphasis in that sentence should be on the word policy. A policy is really a sort of rule—sometimes explicit, sometimes only implicit—that lays out a decision maker's objectives and how they are going to be attained. The objective of a policy of monetizing the debt is to create inflation as a means of lowering the burden of government debt by lowering the value of the debt and interest the government must repay in inflation-adjusted terms.

Monetizing debt is decidedly not the current policy of the Federal Reserve, at least not according to Federal Reserve Chairman Ben Bernanke. Speaking at a recent conference hosted by the Federal Reserve Bank of Atlanta, Chairman Bernanke was unequivocal: "We are not in the business of trying to create inflation."

So what business is the Fed in?

In short, the Fed's so-called dual mandate charges the FOMC with promoting sustainable growth and low and stable inflation. Though the economy is moving forward, it is doing so at a pace that is only slowly yielding job growth. This forward momentum has not yet proved robust or sustained enough to dent the unemployment rate.

More important, the economic landscape at the end of the summer was colored by the continuation of a declining inflation trend that was bleeding into expectations about the probability of deflation. In a still-recovering economy with very low interest rates, the emergence of deflation expectations would be a most unwelcome development that could seriously impede the prospect for continued recovery.

As Atlanta Fed President Dennis Lockhart has said, stabilizing inflation expectations is a key to policy success, and "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."

The policy represented by the November decision appears to be working. As markets came to expect the November announcement, price expectations that had been declining all summer began to stabilize and have now returned to pre-summer levels.

Could the policy be too successful? That is, there a risk that the policy will overshoot and replace declining inflation rates with too-high inflation rates?

There are, of course, always risks to action and inaction. Now that the FOMC's action has apparently mitigated the risk of a recovery-threatening disinflationary spiral, at some point it will be appropriate to turn attention to inflation risks. As President Lockhart recently commented, we at the Atlanta Fed are confident these decisions will be made independent of fiscal considerations.

The current focus is on rising commodity prices, and the Federal Reserve, including the Atlanta Fed, is watching those developments too.

As one of the 12 Federal Reserve Banks charged with bringing a real-time sense of the economy to the monetary policy process, the Atlanta Fed queries hundreds of contacts every month. In general, our contacts, while acknowledging some rising cost pressures, do not indicate they are likely to respond with price hikes of their own.

But we will keep asking, watching for signs that things are changing, and preparing in the event that a change in course is warranted.

And this vigilance is precisely the point. Intentions do matter, and President Lockhart has made his very clear: "Rest assured, should inflation begin to move above desired levels, I am confident the FOMC will work hard to keep it from getting away from us."

By Dave Altig, senior vice president and research director at the Atlanta Fed

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