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The End of Asset Purchases: Is That the Big Question?

Last Friday, Atlanta Fed President Dennis Lockhart delivered a speech at the University of Mississippi, the bottom line of which was reported by the *Wall Street Journal*'s Michael Derby:

> Federal Reserve Bank of Atlanta President Dennis Lockhart said Friday that central bank policy must remain very easy for some time to come, although he cautioned the exact mix of tools employed by the central bank will change over time...
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> "Monetary policy overall should remain very accommodative for quite some time," Mr. Lockhart said... "The mix of tools we use to provide ongoing monetary stimulus may change, but any changes will not represent a fundamental shift of policy"...

That's a pretty accurate summary, but Derby follows up with commentary that feels somewhat less accurate:

> The big question about Fed policy is what the central bank does with its $85 billion-per-month bond-buying program. It had widely been expected to start slowing the pace of purchases starting in September, but when it didn't do that, expectations went into flux. Ahead of the jobs data Friday, many forecasters had gravitated to the view bond buying would be trimmed some time next spring. Now, a number of forecasters said the risk of the Fed slowing its asset buying sooner has risen.

Now, the views that I express here are not necessarily those of the Federal Reserve Bank of Atlanta. But in this case, I think I can fairly claim that what President Lockhart was saying was that the big question is *not* "what the central bank does with its $85 billion-per-month bond-buying program." The following part of President Lockhart's speech—reiterated today in a speech in Montgomery, Alabama—is worth emphasizing:

> The FOMC [Federal Open Market Committee] is currently using two tools to maintain the desired degree of monetary accommodation—the policy interest rate and bond purchases. Importantly, the FOMC has stated that it intends to keep the short-term policy rate low at least until the unemployment rate falls below 6 1/2 percent. This "forward guidance" is meant to convey a sense of how long short-term interest rates will stay near current levels.
> There is some confusion about how the Fed's forward guidance and asset purchase program relate to each other. I will give you my view.
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> In the toolkit the FOMC has at its disposal, there is a sense in which asset purchases and low policy rates are complementary. Asset purchases and forward guidance on interest rates are complements in the sense that they are both designed to put downward pressure on longer-term interest rates....
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> But there is also a sense in which these tools are substitutes. By substitutes I mean that guidance pointing to a sustained low policy rate and asset purchases are discrete tools that can be deployed independently or in varying combinations. They can be thought of as a particular policy tool mix chosen to fit the circumstances at this particular phase of the recovery.

In other words, there is an important difference between changing the amount of monetary stimulus and changing the tools deployed to provide that stimulus. When the only tool in play is the federal funds rate, equating adjustments in the Fed's policy rate with changes in the stance of monetary policy is, while not completely straightforward, relatively simple. With multiple tools in use, however, gauging the stance of monetary policy requires that the settings of all policy instruments be considered.

Suppose that the FOMC does scale back or end its asset purchases? Can that possibly be consistent with maintaining a constant degree of monetary stimulus? Sure, and one obvious option is to use adjustments to the forward guidance portion of the FOMC's current policy to provide additional stimulus as asset purchases are scaled back. There are pros and cons to that approach, many of which surfaced in the discussion of this paper, by the Federal Reserve Board's Bill English, David Lopez-Salido, and Bob Tetlow, which circulated last week. (See, for example, here, here, and here.)

In any event, a decision to replace asset purchases with some other form of stimulus—be it extending forward guidance or another alternative—would necessarily raise the question: Why bother? One answer might arise from the cost and efficacy considerations that the FOMC has identified as part of the calculus for whether to continue with asset purchases.

Here again, the fact of multiple tools is germane. With the option of different policy mixes, altering the asset purchase program on grounds of cost or efficacy need not mean that the costs of the program are large or the purchases themselves lack effect. It need only mean that the costs might be larger, or the purchases less effective, than providing the same set of stimulus with some alternative set of tools. I give the last word to President Lockhart:

> Going forward, it may be appropriate to adjust the policy tool mix. That will depend on circumstances and the economic diagnosis of the moment.

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