CENTRAL to AMERICA'S ECONOMY™

QE2 in Five Easy Pieces

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Any views expressed here are my own and do not necessarily reflect the views of others on the Federal Open Market Committee.

The FOMC decision

- The FOMC voted to pursue "QE2" last week.
- Even before this action, monetary policy was ultra-easy:
  - The Committee's policy rate is near zero, and projected to remain there for an "extended period."
  - The Fed's balance sheet, at $2.3 trillion, is much larger than it was pre-crisis, and the Committee has established a policy of replacing maturing securities.
- After the November meeting, the Committee stated that:
  - The Fed will purchase Treasury securities at a pace of about $75 billion per month through the first half of 2011.
  - The Committee will regularly review the program.

What this talk is about

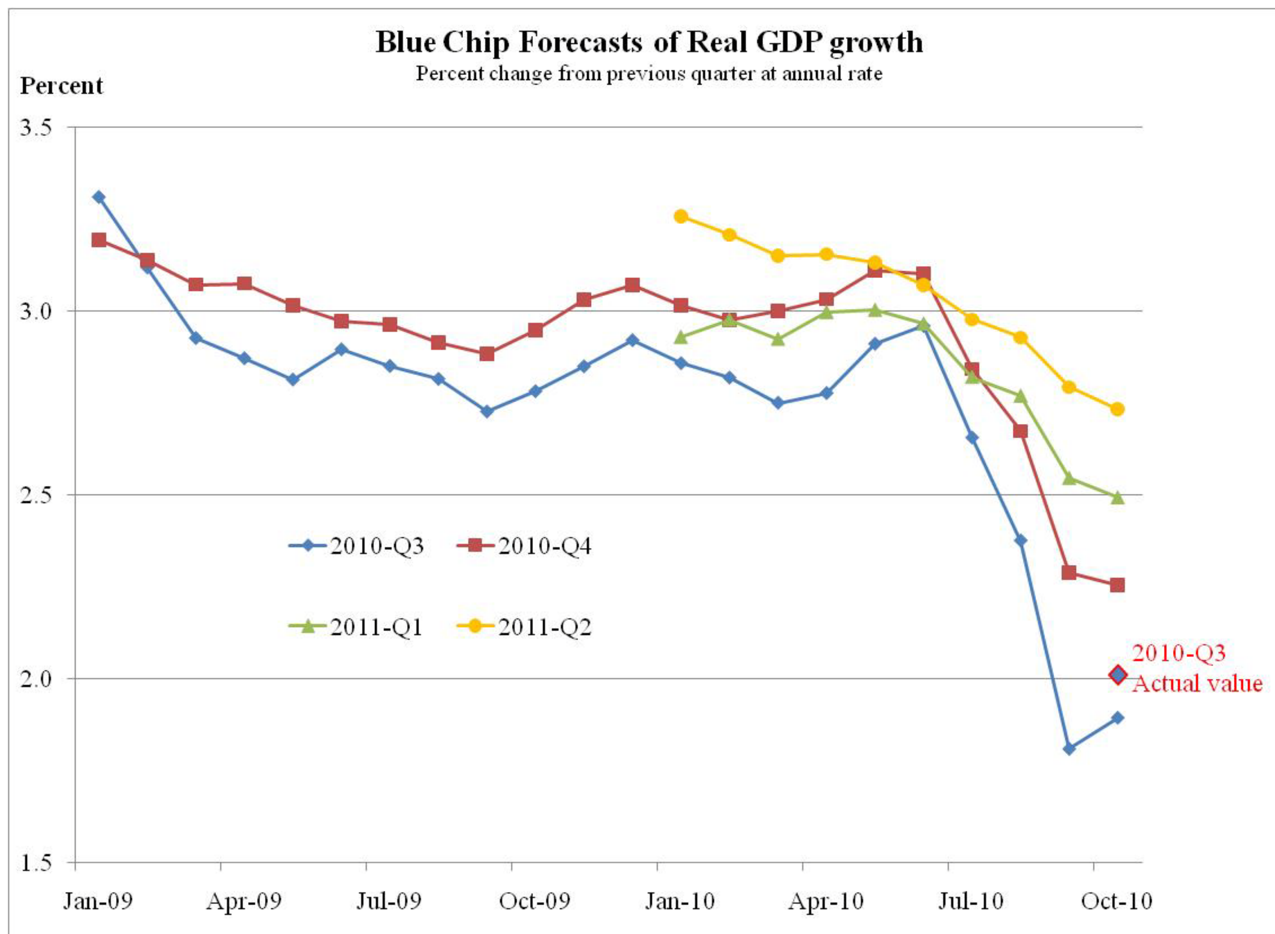
- I will give my view of the November decision in five easy pieces:
  - I. The pace of recovery slowed, creating a disinflationary trend.
  - II. Japanese experience indicates that a near-zero nominal interest rate, mildly deflationary equilibrium exists and is difficult to escape.
  - III. Monetary policy should be directed to avoiding this outcome, but U.S. short-term interest rates are already approximately zero.
  - IV. Asset purchases can substitute for ordinary monetary policy, and have had conventional financial market effects.
  - V. Maximum effects on the real economy take 6 to 12 months and can be difficult to disentangle, but should be conventional as well.

Risks and rewards

- The new policy carries both risks and rewards.
- I will discuss some of the risks in the second part of the talk.
- I think the benefits outweigh the risks, but the risks are very real.
- Let’s get started on the five easy pieces.

I. Slower Recovery and Disinflation

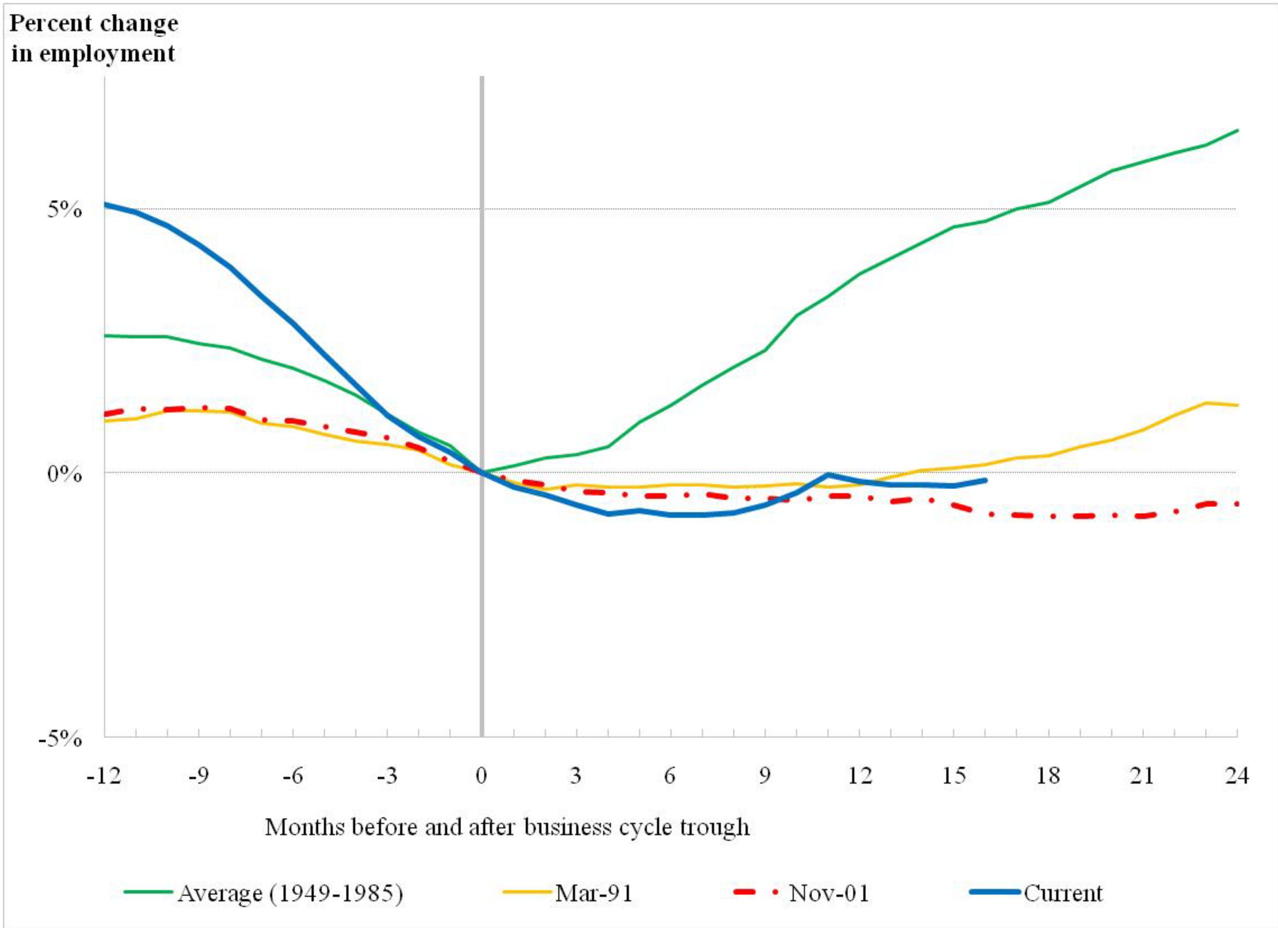
Forecasts were marked down during the summer



Labor markets remain weak

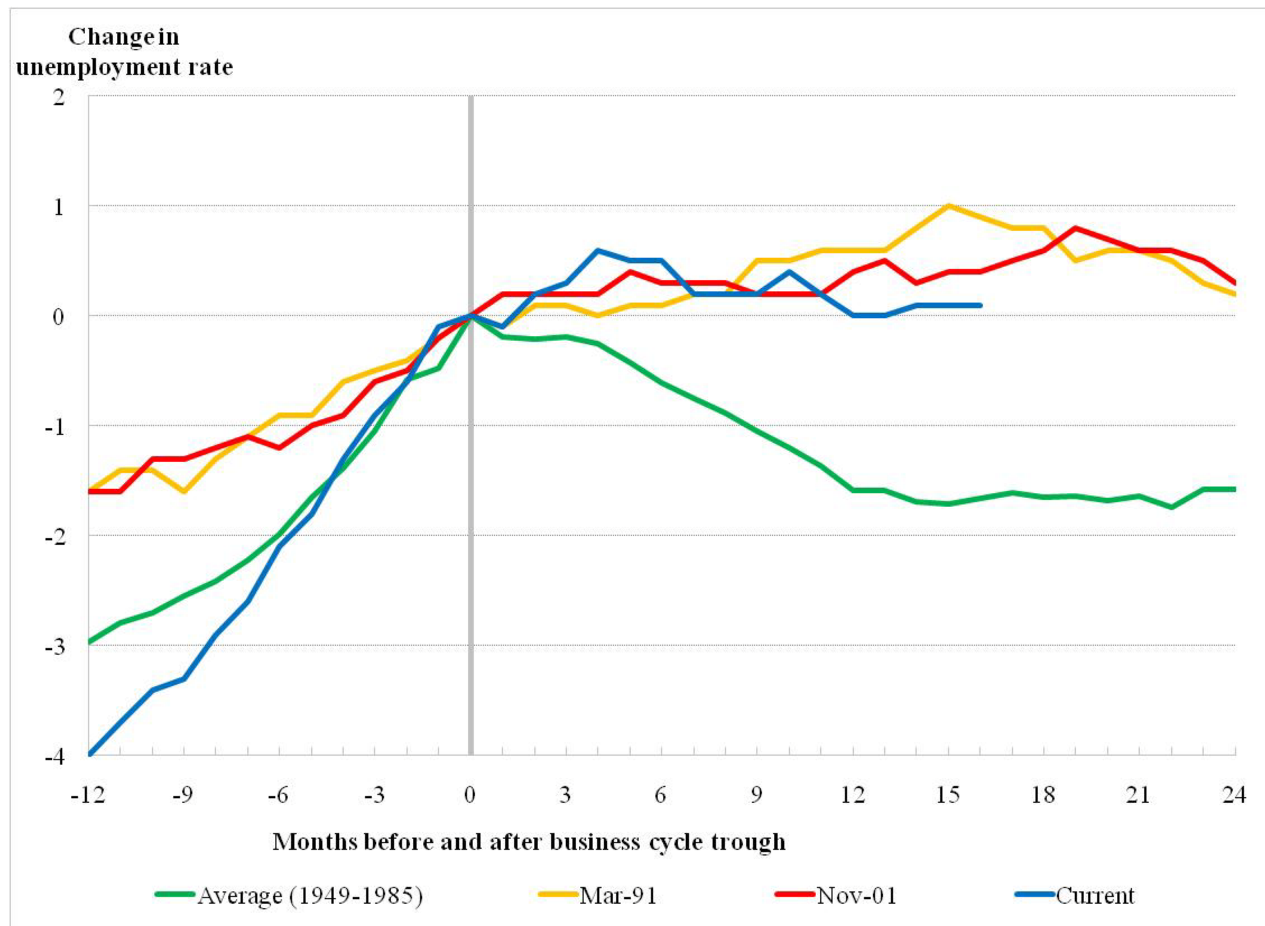
- I expect labor markets to lag the recovery.
- Labor market behavior since the end of the 2007-09 recession so far looks a lot like the aftermath of the 1990-91 recession and the 2001 recession.

Employment: comparing recoveries



Source: BLS data and author's calculations. Last observation: October 2010.

Unemployment: comparing recoveries



Source: BLS data and author's calculations. Last observation: October 2010.

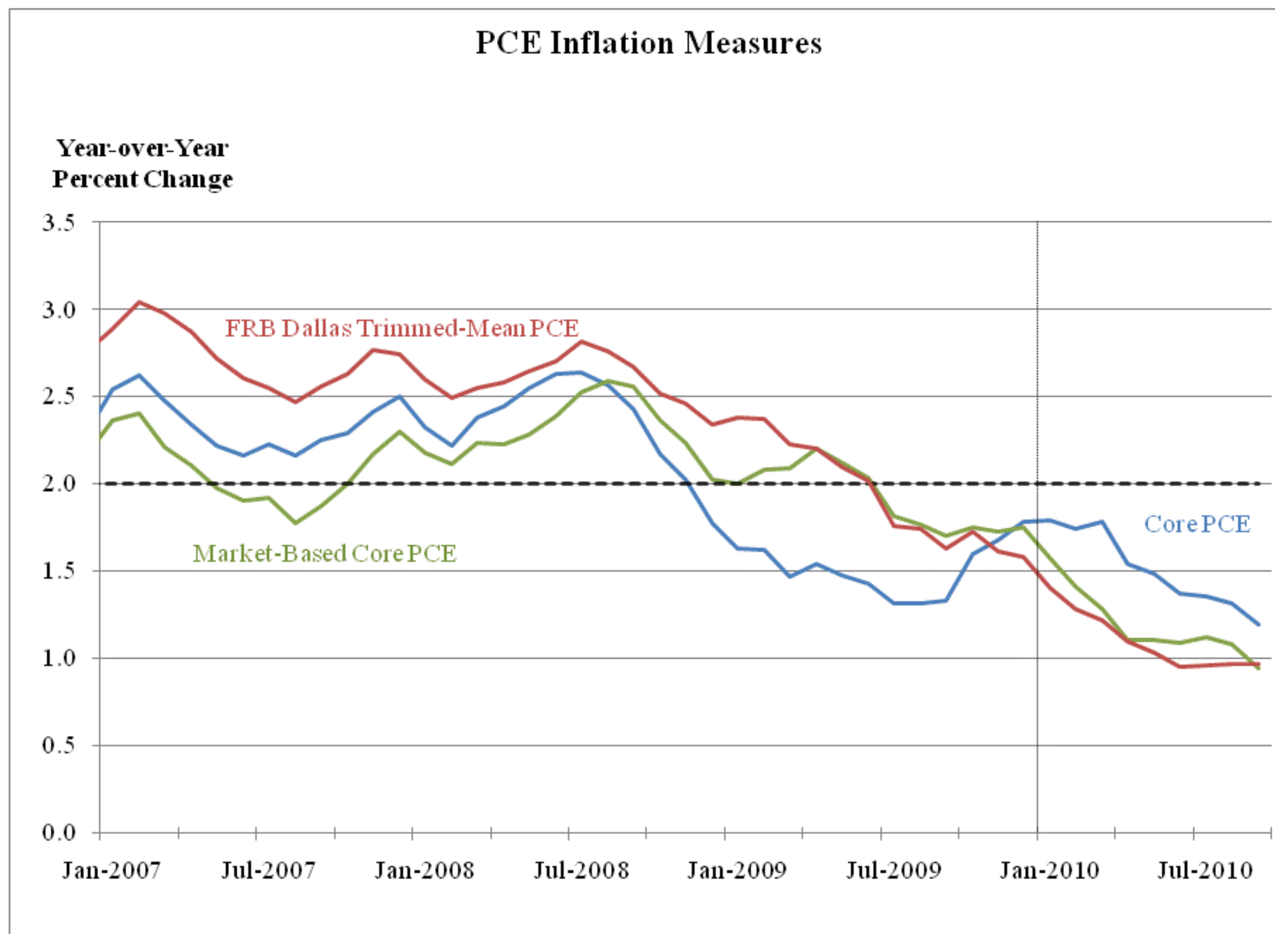
Structural change in labor market behavior?

- These two graphs suggest that labor market behavior following recessions has changed since the pre-1985 postwar era.
- According to these data, this is the third post-recession period in a row with tepid labor markets.
- It may be unreasonable to expect pre-1985 labor market behavior when we have not observed it for 25 years.
- This is an important area for research.

A disinflation trend in 2010

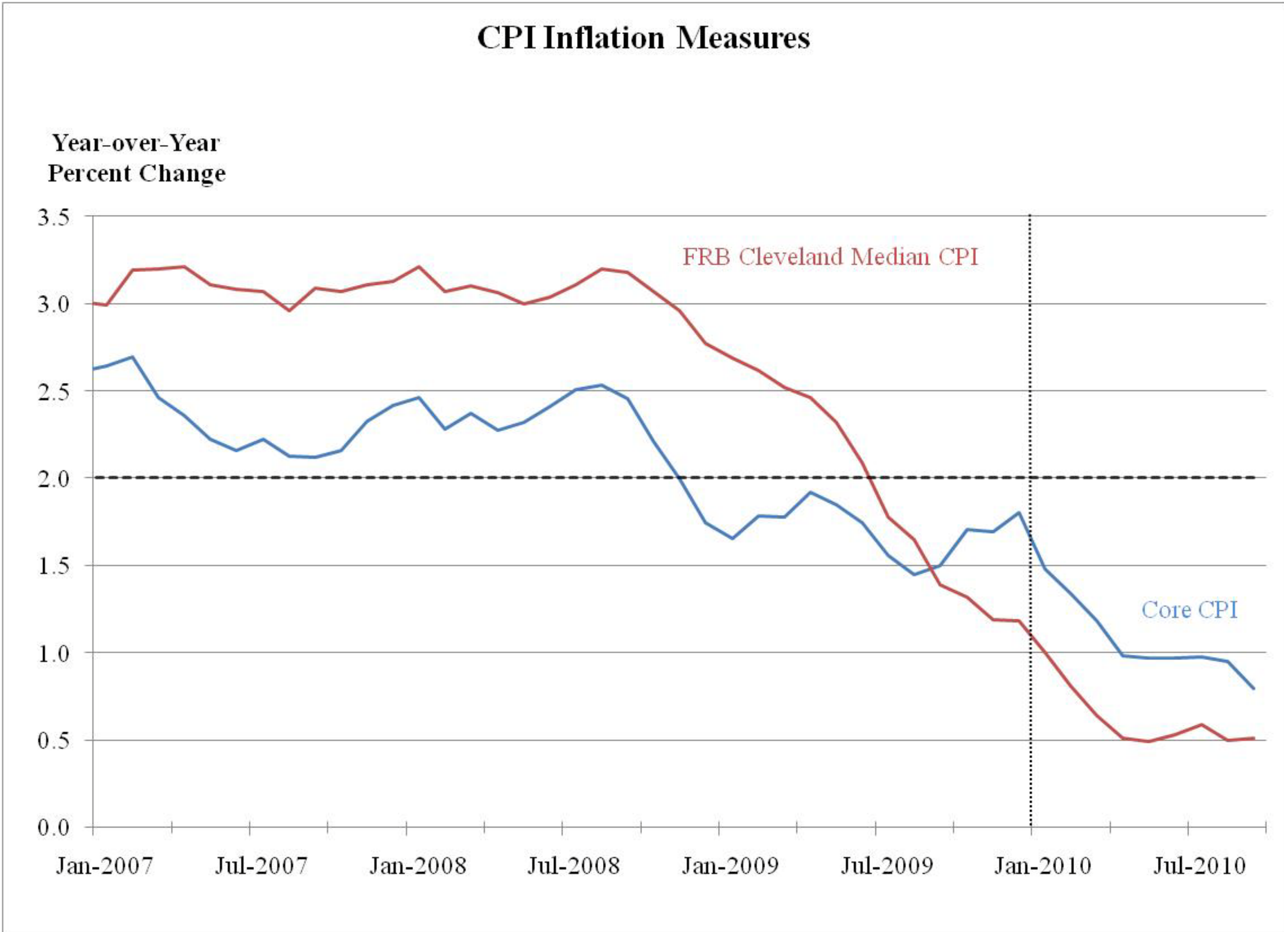
- Inflation was close to the implicit FOMC inflation target during the first part of 2010.
- During 2010, a clear disinflation trend developed.

Disinflation trend in 2010, PCE



Source: BEA and FRB Dallas. Last observation: September 2010.

Disinflation trend in 2010, CPI



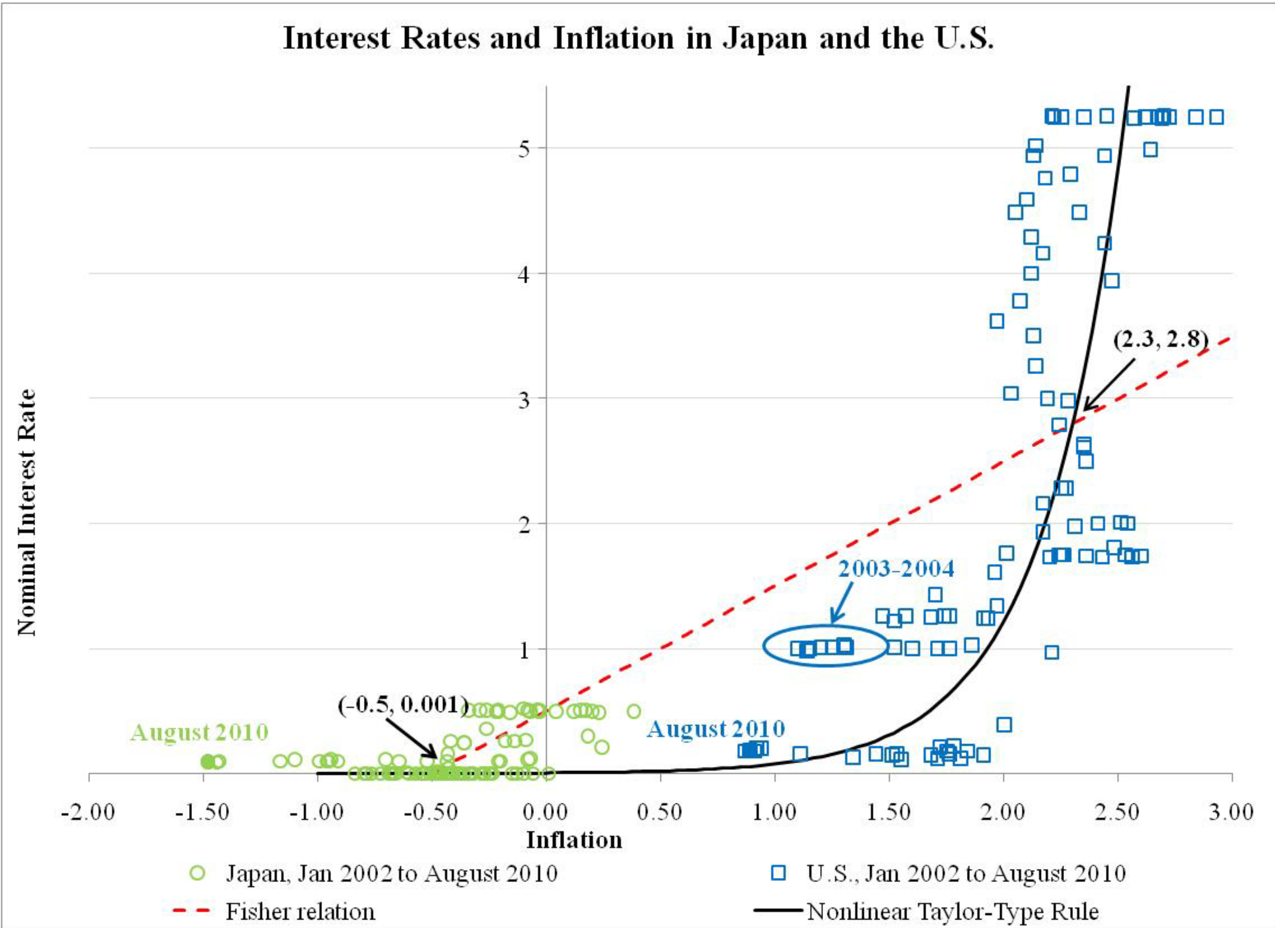
Source: BLS and FRB Cleveland. Last observation: September 2010.

II. Lessons from Japan

Inflation and nominal interest rates

- Taylor-type policy rules in combination with a Fisher relation creates two possible long-run outcomes for the macroeconomy.
- Japan has been in one of these, the U.S. in the other.
- The Japanese experience has generally been regarded as disappointing.
- U.S. policy should strive to avoid this possibility.
- For more commentary, see my paper "Seven Faces of the Peril," posted on my web site.

Interest rates and inflation in Japan and the U.S.



Source: OECD data and author's calculations. Last observation: August 2010.

The near-zero interest rate policy

- Keeping the policy rate near-zero may push the economy toward the targeted steady state.
- However, the policy is also consistent with the unintended steady state, where there is mild deflation.
- It may not be prudent to rely on low policy rates alone to keep the U.S. out of the deflationary outcome.
- Instead, supplement current interest rate policy with additional QE.

III. Policy Strategy

Policy strategy

- What to do given (1) a slower recovery with a disinflationary trend, and (2) knowledge of what happened in Japan?
- Avoid further disinflation.
  - Further disinflation with short-term nominal interest rates at zero would mean rising real interest rates in the face of a slowing pace of recovery.
  - It would be difficult to escape the low nominal interest rate, mildly deflationary equilibrium that Japan has experienced.
- Defend the Committee's implicit inflation target from the low side as we would from the high side.

IV. Asset Purchases

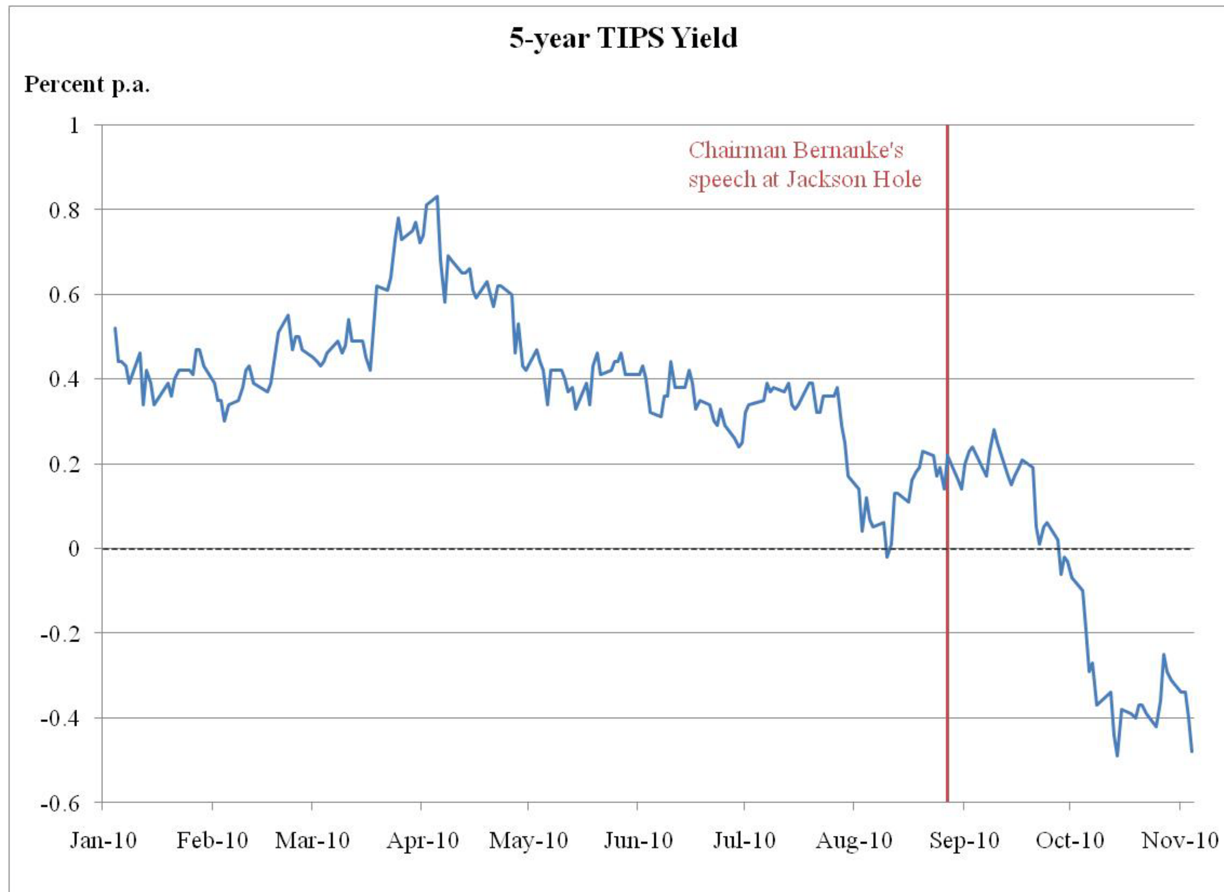
Implementation via asset purchases

- Ordinary monetary policy would lower short-term nominal interest rates, but those rates are already near zero.
- Asset purchases of Treasury securities at longer maturities can substitute for ordinary monetary policy.
- This puts downward pressure on nominal interest rates further out the yield curve, along with upward pressure on expected inflation.
- Accordingly, the policy puts downward pressure on real interest rates.

The effects of asset purchases

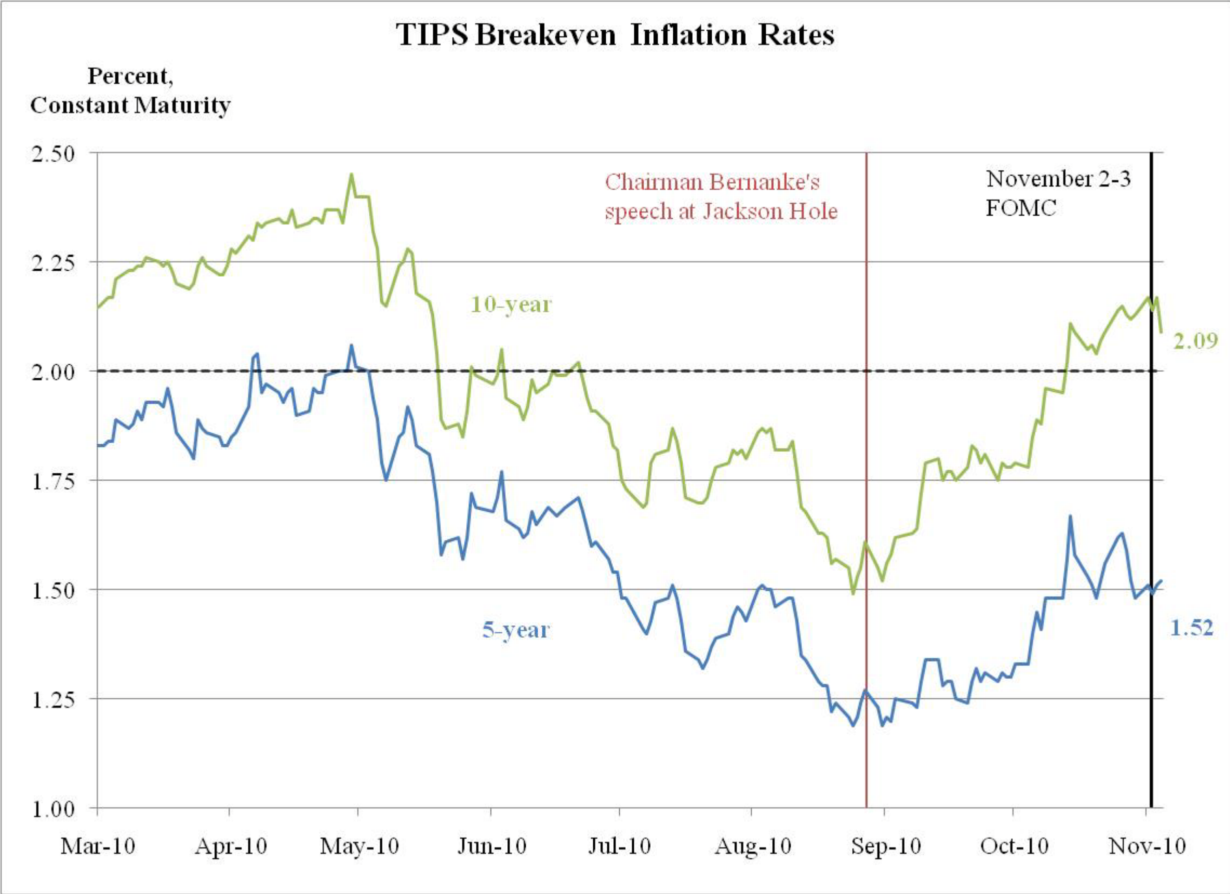
- The policy change was largely priced into markets ahead of the November FOMC meeting.
- While asset purchases are sometimes viewed as unconventional, the financial market effects have been entirely conventional.
- In particular, real interest rates declined, inflation expectations rose, the dollar depreciated, and equity prices rose.
- These are the same financial market effects one might observe when the Fed eases monetary policy in ordinary times (that is, in an interest rate targeting environment).

Real interest rates declined



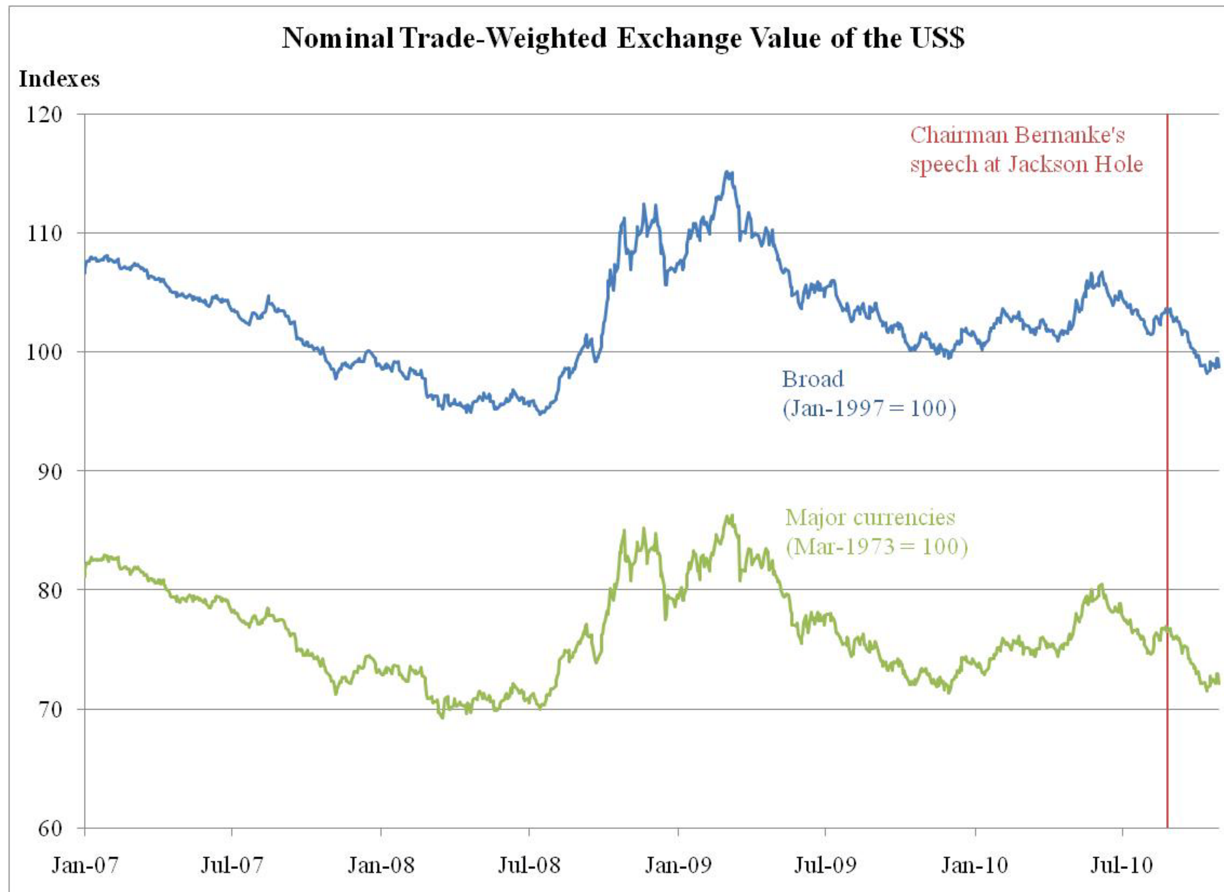
Source: Federal Reserve Board. Last observation: November 4, 2010.

Expected inflation increased



Source: Federal Reserve Board. Last observation: November 4, 2010.

The dollar depreciated



Source: Federal Reserve Board. Last observation: September, 2010.

Equity prices increased

Source: Wall Street Journal. Last observation: November 4, 2010.

V. Effects on the Real Economy

The effects on the real economy

- The financial market effects have been entirely conventional.
- An easing of monetary policy produces its maximum impact on real variables in the economy, including output, consumption, and investment, with a lag of 6 to 12 months.
- Economic performance will be influenced by other developments during this period, so it will be difficult to disentangle the real effects of the policy action from other influences on the economy.
- However, this is a standard problem in discerning the real effects of monetary policy.
- Most likely, the real effects will be just as conventional as the financial market effects.

Risks and Criticisms

Risks and criticisms

- The FOMC's asset purchase program also entails some risks, and has encountered criticism.
- I will now close this talk by listing and discussing a few of these.

Risks and criticisms: "The program will not work."

- Many have argued that asset purchases would not be effective.
- I have argued that the financial market effects of the program have been about what one would expect from an easing of monetary policy.
- The real effects will likely peak with a lag of 6 to 12 months, but will be hard to disentangle from other factors.

Risks and criticisms: "This is a replay of the 1970s."

- My monetarist friends are anxious to avoid creating too much inflation.
- This is a legitimate and important concern.
- If inflation were to rise too high, the Committee might lose its hard-earned credibility for maintaining low and stable inflation.
- I have argued that the 2010 disinflationary trend is worrisome right now, but I completely agree that keeping inflation near the Committee's implicit inflation target is very important for maintaining credibility.

Risks and criticisms: "The Fed is monetizing the debt."

- The Committee has often stated its intention to return the Fed balance sheet to normal, pre-crisis levels over time.
- Once that occurs, the Treasury will be left with just as much debt held by the public as before the Fed took any of these actions.
- It is absolutely imperative that the Congress and the President attack the long-run budget problems the nation faces.
- Europe has given the U.S. an important wake-up call on how devastating it can be to leave long-run structural deficit problems unaddressed.

Conclusion

Conclusion

- I have tried to relay some of my own thinking on the recent FOMC decision to pursue QE2.
- I described the policy in five easy pieces.
- My view puts weight on the idea that the 2010 disinflationary trend is a concern.
- The asset purchase program entails risks which are very real.
- In my judgment, the likely benefits outweigh the risks.

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