



**What's Next for US Monetary Policy?
An Accomodative Put**

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The medium term outlook for U.S. monetary policy continues to be tilted towards creative, risk-influenced and risk-influencing, expansionary policies. The first sign of creative, risk influence monetary policy during the Great Recession -- as apart from the aggressive decisions the Federal Reserve Board took to stabilize the financial system as part of its broader central bank mandate -- was QE2. I signed the open letter that was published on November 16, 2010 in the Wall Street Journal that argued against the Federal Open Market Committee's (FOMC's) decision to engage in the Quantitative Easing action QE2. I did so because I believed that the costs from QE2 exceeded the benefits to this particular expansion of the Federal Reserve's balance sheet. The economic results from QE2 were decidedly mixed. Long term interest rose rather than fell, opposite to what QE2 advocates predicted, although economic activity, commodity prices and stock prices did firm.

While QE2 may have mixed economic results, this policy and subsequent ones by the FOMC have eroded confidence and predictability in the commonly understood framework for monetary policy to obtain macroeconomic outcomes. Indeed, recent operations such as "Operation Twist," as well as and the announcement of the future conditional path of the federal funds for several years, are all creative attempts to extend the effectiveness of monetary policy to accomplish macroeconomic objectives. However, these innovative attempts to use policy to obtain mandated macroeconomic objectives appear disconnected as part of an overall strategy. One could argue, that this disconnection has lowered the Fed's level of transparency, since how can a policy be transparent if you don't know if a new policy will be in place the next time that a decision needs to be made?¹ Moreover, these policies are likely to be risk inducing in the long run, particularly as these policies are eventually unwound or modified as new policies emerge.

Understanding, framing and articulating the economic basis for a monetary policy strategy to obtain macroeconomic objectives is essential to its ultimate success. This is particularly true since monetary policy works, in large part, through market participants' expectations. For example, the Federal Reserve should be applauded for directing the market's focus to understand that low and stable inflation of 2% is foundational to the Fed's dual mandate from Congress to provide price stability and maximum employment.

That being said, the Fed's commitment to delivering low inflation as part of its commitment to a dual mandate is somewhat at odds with its current favored emphasis between the components of the dual mandate. As a first example, leading members of the Federal Reserve have continued to argue that monetary policy can be used to lower elevated levels of unemployment by accelerating short to medium term economic growth. Examples of such thinking have been championed by Federal Reserve Board Vice Chairwoman Janet Yellen (April 11, 2012) and Federal Reserve Bank of Chicago President Charles Evans (September 7, 2011).² Unfortunately,

¹This may explain why the public dubs each new Federal Reserve balance sheet operation in numerical order, e.g. QE1, QE2, QE3, while Fed officials bristle at the lack of nuance in this approach as they believe that each of these operations has had distinct objectives and operational strategies. However, the public may prefer the numbering of different co-mingled strategies in that it gives Fed policy the semblance of a well connected sequence of policy actions that are part of a larger strategy.

² Janet L. Yellen, "The Economic Outlook and Monetary Policy," April 11, 2012. Speech at the Money Marketeters of NYU. <http://www.federalreserve.gov/newsevents/speech/yellen20120411a.htm>; Charles Evans, "The Fed's Dual Mandate: Responsibilities and Challenges Facing U.S. Monetary Policy." Speech at the European Economic and

the Federal Reserve has historically done poorly when trying to engineer consistent declines in the rate of unemployment by using Aggregate Demand policy in the face of Aggregate Supply constraints and shortfalls. For instance, it is now commonly accepted monetary policy wisdom that an overly accommodative monetary policy stance adopted by the Federal Reserve in the 1960's and 1970's, in an effort to lower the unemployment rate and erase a misperceived output gap, unhinged inflation expectations and led to the Great Inflation.

A second strain on the Fed's long run commitment to low inflation is that the Fed has typically articulated a sharply asymmetric perspective about increases in observed inflation as compared to decreases in observed inflation. Typically, when headline inflation rises above core measures of inflation, the FOMC has shown considerable patience in tightening monetary policy – see Hilsenrath and Dogherty (April 13, 2012). Indeed, as of March 2012, annual consumer price increases are 2.7%, and yet the Fed has to reconcile inflation above target with its strong desire to keep policy accommodative in order to focus on elevated rates of unemployment.³ By contrast, when headline inflation has declined below core measures of inflation, the FOMC has been quick to treat disinflation as evidence of the origin of systemic deflation, and undertaken swift and extraordinary policy actions to expand policy. Both the 2001-2003 extended low interest rate policy and the genesis of our current near zero interest rate policy are prime examples. Such asymmetric policy responses are not easy to communicate, frame, or make digestible to the public, and therefore challenge the Fed's ability to create confidence in the operations of creative monetary policy. Moreover, it will be hard for the Fed to maintain its long run desired inflation objective if it treats positive movements in inflation as temporary phenomena to be ignored, yet negative movements in inflation as harbingers of crisis that need all hands on deck.

Monetary policy has a bias towards accommodation due both to the Fed's decision to continue to stimulate further economic growth at all costs in order to lower unemployment, and given its asymmetric response to inflation. However, future actions by the Fed will not be constrained simply by macroeconomic management, which we already see is slanted towards overly accommodative measures. Sovereign debt challenges in Europe now prevail, and subsequent systemic risk remains an important driving force for additional liquidity operations by the Federal Reserve. So, to end where I began, monetary policy remains on a risk influenced and risk influencing, expansionary path, and notwithstanding the FOMC's commitment to a 2% inflation rate, be prepared for this inflation objective to be demoted as a primary determinant of policy given the Fed's macroeconomic management and its likely response to any sovereign debt crisis that could emerge.

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http://www.chicagofed.org/webpages/publications/speeches/2011/09_07_dual_mandate.cfm

³ Jon Hilsenrath and Conor Dougherty, "Consumer Price Rise Puts Fed in Quandry," April 13, 2012, *The Wall Street Journal*."

<http://online.wsj.com/article/SB10001424052702304356604577341463030931388.html?KEYWORDS=hilsenrath>