U.S. Monetary Policy:
Overview and Recent Actions

The CA Association of County Treasurers and Tax Collectors
2013 Annual Conference
June 12, 2013
Monterey, CA

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Overview

1. Roles of the Federal Reserve
2. Goals and tools of U.S. monetary policy
3. Recent monetary policy actions and their impact on the economy:
   – Large scale asset purchases (LSAPs) / QE
   – Forward policy guidance

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Roles of the Federal Reserve

• Supervising and regulating banks and other important financial institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers.

• Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.

• Providing certain financial services to the U.S. government, U.S. financial institutions, and foreign official institutions, and playing a major role in operating and overseeing the nation's payments systems.

• Conducting the nation's monetary policy.
Congress has set these two monetary policy goals for the Federal Reserve:

1) Promote maximum sustainable output and employment

2) Promote stable prices

Statement of FOMC’s longer-run goals and policy strategy (Jan 2012)

- Inflation target of 2 percent
- Estimates of the longer-run normal rate of unemployment with a central tendency of 5.2 to 6 percent

Intermediate Policy Objectives

• Conventional Monetary Policy
  – Target short-term interest rates
  – Provide liquidity to banking institutions

• Unconventional Monetary Policy
  – Influence long-term interest rates more directly
  – Provide liquidity more broadly to the financial system
Tools for Achieving Intermediate Policy Objectives

**TOOLS**

**Interest Rate Policies:**
- Open market operations (conv.)
  - used in conjunction with paying interest on reserves
- Large-scale asset purchases (unconv.) – LSAPs or QEs
- Communications
  - Transparency
  - Forward guidance

**Providing Liquidity:**
- Discount window (conv.)
- New credit facilities (unconv.)

**OBJECTIVES**

- Target federal funds rate
- Affect long-term rates more directly
- Affect short-term and long-term rates
- Provide liquidity to depository institutions
- Provide liquidity to the financial system
Long-term interest rates are determined by:

- **Short-term interest rate**
- **Expected short-term interest rates**
- **Term premium** (compensation investors require to hold assets for longer periods of time instead of holding a series of short-term instruments)
  - affected by supply of long-term securities available to the public
Conventional Tools of Monetary Policy: Target Federal Funds Rate (Feeds Through to Longer-Term Rates)
“Conventional” Policy Rule: At the Depth of the Recession, with Inflation Falling and The Unemployment Rate Around 10%, a Zero Fed Funds Rate Target Was Not Low Enough
Moving Long-Term Rates at Zero Lower Bound

- **Forward Guidance**
  - Affects public interest rate expectations

- **Large Scale Asset Purchases (LSAPs)**
  - *Signaling channel*
    - Affects public expectations of short-term interest rates
  - *Portfolio channel*
    - LSAPs reduce supply of long-term securities available to the public, reducing term premium

*Note:* The Fed’s authority to pay interest on reserves (effective date: October 1, 2008) was a necessary step to facilitate balance sheet policies.
Large-Scale Asset Purchases: Background

**LSAP 1 (often referred to as QE1) -- $ 1.7 trillion**
- 11/25/2008—announcement of purchases of up to $100 billion in agency debt and up to $500 billion in agency MBS.
- 3/18/2009—announcement of purchases of up to an additional $750 billion of agency [MBS], $100 billion in agency debt, and $300 billion in Treasury securities.

**LSAP 2 (often referred to as QE2) --- $ 600 billion**

**Maturity Extension Program (MEP or called “Operation Twist”)**
- Announcement of purchase $400 billion in long-term Treasuries, to be financed by sales of short-term Treasuries.
- June 20, 2012: Extension of maturity extension program through year-end.
Large-Scale Asset Purchases: Background

- LSAP 3 (Often referred to as QE3) -- $85 billion / month
  - 09/13/2012 announcement to purchase additional agency-backed mortgage-backed securities (MBS) at a pace of $40 billion per month
  - 12/12/2012 announcement to purchase longer-term Treasure Securities at a pace of $45 billion/month

- Open ended and contingent on economic conditions
  - Looking for substantial improvement in the job market outlook, providing inflation remains low
Unconventional Monetary Policy Actions Increased the Size and Changed the Composition of the Federal Reserve Balance Sheet
Large-Scale Asset Purchases: Estimated Impact

- LSAP1 (often referred to as QE1): $1.7 trillion purchases of Treasury and agency securities reduced yield on 10-year Treasury securities by between 40 and 110 basis points.


- Maturity Extension Program (MEP): Likely similar to LSAP2

- QE3/LSAP3: $40B MBS & $45B long-term Treasuries each month. More challenging to estimate because it is open ended; had a large impact effect on MBS rates.
Inflation Has Remained Subdued

Personal Consumption Expenditure Price Index
Year-over-year percent change

Source: BEA
6/10/2013
U.S. Unemployment Rate Declined from Recessionary Peak, but Progress Remains Slow and the Rate Remains Elevated

Unemployment Rate
In percent; seasonally adjusted

Source: Bureau of Labor Statistics
6/10/2013
THE IMPORTANT ROLE OF TRANSPARENCY

“Never explain, never excuse!”
Montagu Norman, Governor of the Bank of England from 1921-1944

“The effects of monetary policy depend critically on the public getting the message about what policy will do months or years in the future.”
Janet Yellen, Vice Chair, Board of Governors of the Federal Reserve System, April 4, 2013 Speech
Transparency helps the public understand the Fed
- Its objectives and strategies
- Its assessments of the economic outlook

Forward guidance provides information on the Fed’s expected policy actions

Benefits of increased transparency and forward guidance
- Reduce economic and financial uncertainty
- Increase effectiveness of monetary policy
- Enhance Fed accountability and legitimacy

Transparency and Forward Guidance: Goals and Benefits
Movements Toward Transparency: Brief History

- **1978**: Testimony to Congress
- **1994**: Announcement of fed funds target, descriptions of the state of the economy and the rationale for the policy action
- **2000**: Added “balance of risks” to the outlook
- **2002**: Released votes of individual members
- **2003**: Added forward-looking guidance on policy
- **2005**: Expedited release of FOMC minutes
- **Nov. 2007**: Added numerical forecasts to the FOMC minutes four times per year, with a 3-year time horizon
- **Feb. 25, 2009**: New website launched by the Board of Governors to provide information on the Fed's policy actions during the financial crisis
- **April 27, 2011**: Chairman’s press conference added

http://www.federalreserve.gov/monetarypolicy/bst.htm
Movement Toward Transparency: Recent Initiatives

- **Statement of FOMC’s longer-run goals and policy strategy (1/25/12)**
  - Introduction of inflation target
  - Estimate of longer-run natural rate of unemployment

- **Qualitative guidance regarding QE3:**
  - Labor market conditions
  - Cost/benefit analysis

- **Quantitative guidance regarding FOMC expectations for the federal funds rate:**
  - Calendar Date
  - Numerical Thresholds
Movement Toward Transparency: Recent Initiatives

- Statement of FOMC’s longer-run goals and policy strategy (1/25/12)
  - Introduction of inflation target
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- Qualitative guidance regarding QE3 (currently $85b/mo):
  - Labor market conditions
  - Cost/benefit analysis

- Quantitative guidance regarding FOMC expectations for the federal funds rate target:
  - Calendar Date
  - Numerical Thresholds
Job Creation Has Picked Up Since September 2012 (When QE3 Was Initiated)

Source: The Economic Outlook and Monetary Policy: Moving in the Right Direction
Forward Guidance for the Federal Funds Rate: Information About Expected “Liftoff date”

- 08/11: “mid-2013”
- 01/12: “late 2014”
- 09/12: “mid-2015”
- 12/12: calendar date-based guidance replaced with numerical thresholds
Exceptionally low range for the *federal funds rate* will be appropriate for *at least as long* as:

1. The unemployment rate remains above 6-1/2 percent
2. Inflation *between one and two years* ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and
3. Longer-term inflation expectations continue to be well anchored
Quantitative Guidance Regarding FOMC Expectations for Future Monetary Policy

March 2013 Meeting

- Appropriate timing of policy firming

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Impact of August 2011 FOMC Statement

Source: FRBSF Economic Letter 2011-31
• The Federal Reserve responded aggressively to the financial crisis of 2007, lowering the target federal funds rate from $5 \frac{1}{4}$ percent to effectively zero to pursue its dual mandate to keep unemployment and inflation low.

• With the short-term interest rates below zero, the Fed turned to unconventional tools to influence long-term interest rates:
  – Forward guidance
  – LSAPs
  – Enhanced Communication

• There is evidence that the Fed’s unconventional policy actions have been effective at lowering interest rates, stimulating economic growth and preventing deflation.
QUESTIONS?

THANK YOU!

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