The Monetary Policy Response and Outlook

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April 16, 2021

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Fed Took Out All the Stops

- Cut short-term rates close to zero
- QE: Treasury and agency MBS purchases
  - Initially to restore market function
  - Later to support more accommodative financial market conditions
- Forward guidance on rates
  - March 2020: “will maintain this target range until it is confident that the economy…is on track to achieve its maximum employment and price stability goals”
  - September: “until labor market conditions…consistent…with maximum employment, inflation has risen to 2 pct and is on track to moderately exceed it for some time.”
- Forward guidance on QE
  - June 2020: “over coming months”
  - Recent Powell press conferences: Too soon to talk about tapering of asset purchases
- Special liquidity facilities to support markets
  - Broadened to include corporate and municipal bond markets

Fed’s Efforts Help Cushion Economic Impact of the Pandemic

- Easy monetary policy supports interest-rate sensitive sectors such as housing and motor vehicles
- Liquidity backstops restore market function
- Financial conditions extraordinarily accommodative
- But benefits accrue unevenly, with higher income households disproportionately aided
- Large employment shortfall (about 8.5 million) concentrated among lower income workers

Revised Long Term Monetary Policy Framework Introduced Last Summer

- Average inflation targeting
  - Seek to hit 2 pct rate on average
  - To keep inflation expectations anchored around 2 pct
  - No specificity as to how long or how large deviations above 2 pct will be tolerated
- Employment objective changed
  - Now “shortfalls” from maximum level
  - Before “deviations”
  - Now one sided, rather than two-sided

The Implications for Monetary Policy

- FOMC statement in Sept 2020 outlines new conditions for lift-off
  - FOMC assesses economy has reached maximum sustainable employment
  - Inflation has reached 2 pct
  - Inflation on track to “moderately exceed 2 pct for some time”
- Potential benefits
  - Less risk of inflation expectations becoming unanchored to the downside
  - Short-term rate peak likely to be higher so more ammunition to cope with future downturns
  - Don’t tighten prematurely if the level of maximum sustainable employment turns out to be higher than anticipated
  - Letting economy run hot may provide greater employment opportunities for less advantaged
- Potential costs
  - More volatility in short-term rates (Fed starts later, goes higher)
  - Policy will have to be made tight
  - Recession risks will be higher as a consequence
    - Potentially harming those who are less advantaged

Compare and contrast to the old regime

- Old regime
  - Begin tightening before you reach full employment
  - Goal is to arrive at neutral MP, 2 pct inflation, full employment at the same time
- New regime
  - Don’t start to tighten until at or beyond maximum sustainable employment
  - Inflation will exceed 2 pct and monetary policy will have to be made sufficiently tight to push the unemployment rate up
- Consequence of the shift already evident
  - Dealers and investors now expect later liftoff
    - Unemployment rate about ½ ppt lower, inflation few tenths higher comparing June and September 2020 surveys

My evaluation

- Good motivations for the changes
  - ZLB risks
  - Uncertainty about what constitutes full employment
- Some fuzziness with respect to inflation is necessary
  - Can’t hit the target precisely
  - Not clear the link between inflation outcomes and inflation expectations
    - If you are credible, then you might not even need to overshoot 2 pct inflation to compensate for past misses
- But Fed officials have emphasized the benefits not the costs
  - Markets happy that Fed tightening a long way off
  - But when the tightening comes it will be larger and faster because the Fed will behind the curve
  - Increases risk of recession
    - Soft landing from below almost impossible
    - Sahm rule: When unemployment rate rises by ½ ppt or more, you always have a full-blown recession
  - There is no free lunch

Monetary policy outlook over next few years

- Stage 1: S-T rates at zero, QE continues at $120 billion per month
- Stage 2: QE taper starts once substantial progress made towards Fed's objectives (probably early 2022)
  - Powell says too early to talk about this yet
- Stage 3: Fed lifts off (not until after taper is complete)
  - Fed says not until 2024
  - Market pricing says some chance as early as late 2022, likely in 2023
- Stage 4: Balance sheet normalization
  - Not until fed funds rate reaches 1 to 2 percent
    - Fed wants room to be able to cut short-term rates
  - Target Fed balance sheet around $5 trillion
    - Bank demand for reserves > $1.5 trillion
    - September 2019 repo volatility shows this
    - Will the Fed ever get there?
- My view
  - Fed likely to start earlier with liftoff than it expects
  - Each phase may be shorter (recovery from GFC a bad model)
  - But who knows—no experience with this type of business cycle