

Dean Croushore Blog About Monetary Policy

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A Happy New Fed Year

The new year should prove to be very interesting for the Federal Reserve. Janet Yellen will take over the helm of the Fed from Ben Bernanke. She will preside over a challenging period for monetary policymakers, who must determine how rapidly the Fed should taper its quantitative easing policy.

The Fed's policymakers agreed to begin tapering at its December meeting, with tapering to begin in January. The decision was that the Fed would continue to purchase both long-term Treasury securities and mortgage-backed securities, but to buy \$5 billion less of them each month; a total of \$75 billion instead of \$85 billion per month.

The Fed's decision to begin tapering came three months later than had been expected earlier in the year. At its September meeting, the Fed had been expected to begin tapering, but it delayed because of the looming government shutdown and weaker-than-expected data, combined with rising long-term interest rates. Since then, the government reached an agreement on government spending and taxes, the economic data improved, and long-term interest rates declined somewhat.

How quickly will the Fed likely continue to taper its bond purchases? The answer depends on the strength of the economy, the movement of inflation, and the response of financial markets. If the economy continues to grow at a fairly steady pace, with the unemployment rate declining, then the Fed might decide to taper by \$10 to \$15 billion at each of its next meetings, until quantitative easing has ended completely. The Fed will change its policy slowly, so as not to jolt markets, and will continually evaluate the progress it has made. Of particular concern is the inflation rate, which has been well below the Fed's 2 percent target for some time.

An important part of the Fed's decision in December was the announcement that the Fed expects to keep short-term interest rates very low for some time to come, even after quantitative easing ends completely. The Fed plans to "... maintain the current range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent...", so short-term interest rates may not rise at all until 2015.

How will Janet Yellen's leadership of the Fed compare with Bernanke's? Yellen is more dovish and more of a Keynesian than Bernanke is. She is a bit more likely to want to err on the side of accommodative policy and seems likely to want to keep interest rates lower longer than Bernanke would. But every Fed chair must seek consensus, and Yellen is no exception. If the economy continues to grow stronger and inflation rises above 2 percent, she will be forced to lead the Fed as it switches to contractionary policy.

The long-run question that no one can answer is: How high will interest rates need to rise to keep inflation at bay? Forecasters currently think interest rates will rise slowly, but in almost every historical tightening episode, forecasters made substantial forecast errors, thinking that interest rates would not rise as much as they actually did. [See M&B Chapter 5 in the Data Bank: How Accurate Are Expectations

of Short-Term Interest Rates? (pages 89-90).] Interest rates are difficult to forecast, so the forecasts generally lag behind actual movements in interest rates. Short-term interest rates generally rise 3 to 4 percentage points from their trough to their peak in an economic expansion. But with a very large monetary base (see M&B Chapter 16), interest rates may have to rise even more than normal to keep inflation from rising significantly.

Chart 1 shows the size of the monetary base since 2007. In the period before the financial crisis in 2008, the monetary base (reserves held by banks plus currency held by the nonbank public) was about \$800 billion. Quantitative easing by the Fed is mainly responsible for the growth of the monetary base to over \$3.6 trillion by the end of 2013, and the base is likely to climb above \$4 trillion in 2014.

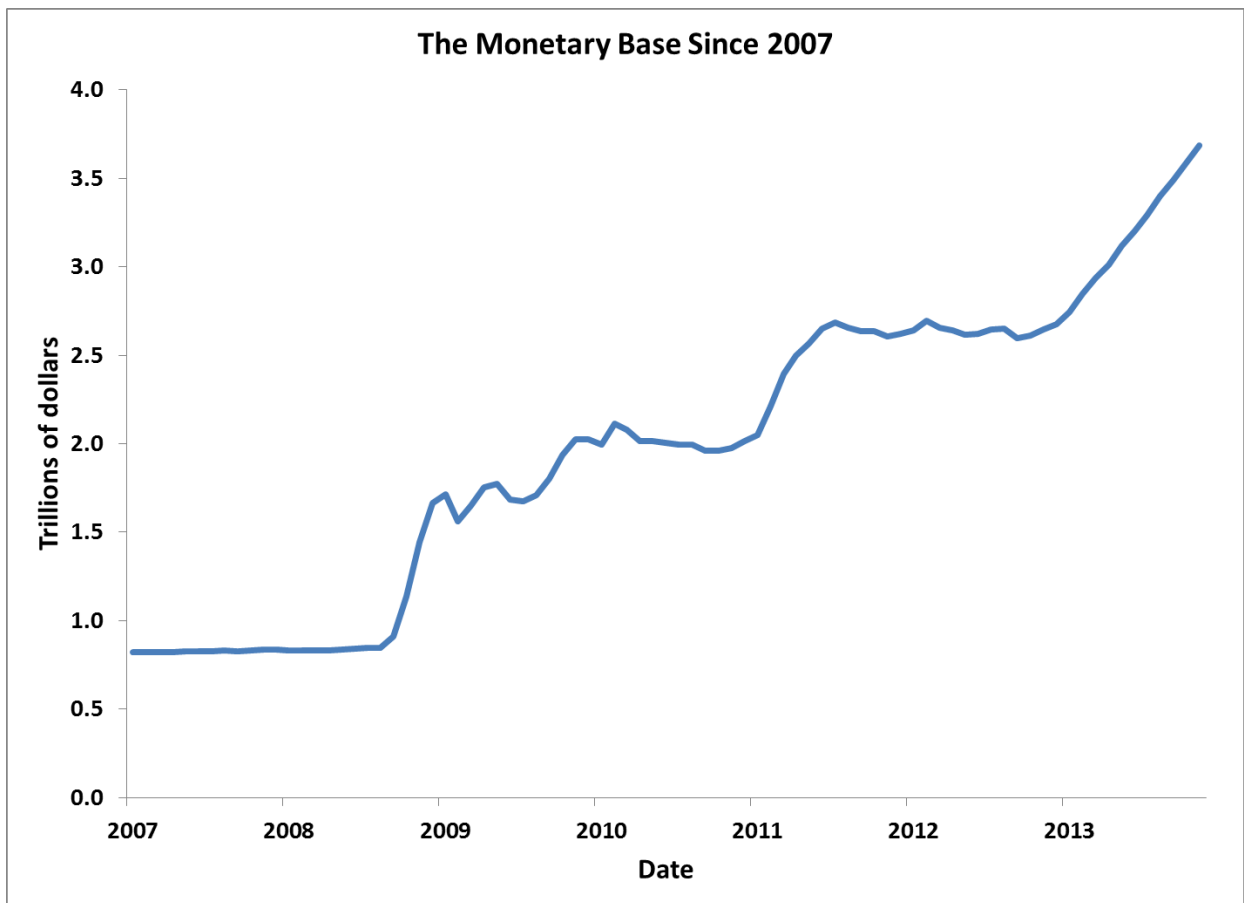


Chart 1. Monetary Base. The monetary base has grown from about \$800 billion before the financial crisis to over \$3.6 trillion by the end of 2013.

In the past, a rapidly growing monetary base has usually been associated with inflation. The Fed is planning to use a number of tools to keep the monetary base from causing inflation. The basic idea of those tools is to keep banks from making too many loans with the reserves they hold. Only time will tell if they will succeed. Most of the tools require the Fed to offer an interest rate to banks on their reserves

that the banks will find more attractive than lending. But we do not know how high that interest rate will be, given the unprecedented size of reserves in the banking system.

We do know, however, that Fed chair Yellen will face a difficult task in coming years, raising short-term interest rates high enough to keep inflation from rising too much, while not raising them so much that they choke off the economy's growth.