Dean Croushore Blog About Monetary Policy

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Quantitative Easing Continues, But Markets Fret

At the June 2013 meeting of the Federal Open Market Committee (FOMC), the Fed did not change the amount of bonds that it is purchasing under its 3rd round of Quantitative Easing (QE3). The Fed tried to clarify, in chairman Bernanke's news conference, how it plans its exit strategy. Chairman Bernanke tried to reiterate that even as the economy is improving, the Fed will continue to purchase bonds and will taper its purchases very slowly and carefully; any changes in its policies will depend on the macroeconomic data in the future. A surprise outcome of the FOMC meeting is that St. Louis Fed president James Bullard dissented, as he is worried that inflation is becoming too low; a position that he has stated in speeches over the past few years.

In response to the Fed's attempt to clarify the situation, financial markets declined. That is, increased selling of both stocks and bonds led their prices to fall; the fall in bond prices means that interest rates increased. Even though the Fed tried to reassure the financial markets that it was not reducing its purchases of assets immediately, the Fed's forecasts for the economy strengthened, and so the markets likely assumed that the Fed would reduce asset purchases sooner than before. At the press conference following the meeting, chairman Bernanke explained that the Fed's exit strategy, in terms of reducing its purchases of assets and eventually raising interest rates, would depend on the macroeconomic data. But some investors may have seen that as simply highlighting the uncertainty about when interest rates would begin to rise, leading them to sell their stocks and bonds in anticipation.

What variables does the Fed look at that suggest that the economy is strengthening? Mainly, it is the steady and gradual improvement in labor markets. The unemployment rate continues to decline steadily, while payroll employment gains have been larger than expected, as Chart 1 shows.

The chart shows labor-market conditions, as measured by the monthly change in payroll employment, as it looked one year ago (green bars) and as it looks today (blue bars). First, you can see that in the past 12 months, the increase in monthly payrolls has been stronger than it was in the previous 12 months. The average monthly increase in payrolls from June 2011 to May 2012 was just under 150,000 jobs per month (green bars), as measured in June 2012. From June 2012 to May 2013, however, monthly payroll growth increased to an average of 176,000 jobs per month (blue bars).

In addition, the data from June 2011 to May 2012 were revised, as you can see by comparing the blue bars to the green bars. In every month from August 2011 to May 2012, you can see that the blue bar is higher than the green bar. What happened is that in early 2013, the Bureau of Labor Statistics released better data on payrolls, leading to a substantial upward data revision. So, the data on which the Fed had based its past policy were incorrect, and in fact the economy had been stronger than the Fed thought at the time. In the revised data, the average monthly increase in payrolls from June 2011 to May 2012 is now 185,000 jobs per month, which is much higher than the previous estimate of under

150,000 jobs per month. (But, notice that based on those revised data, payroll growth was higher from June 2011 to May 2012 at 185,000 jobs per month than it was from June 2012 to May 2013, at 176,000 jobs per month. However, given the imprecision of the initial data and the likelihood of revisions, this difference is not significant.)

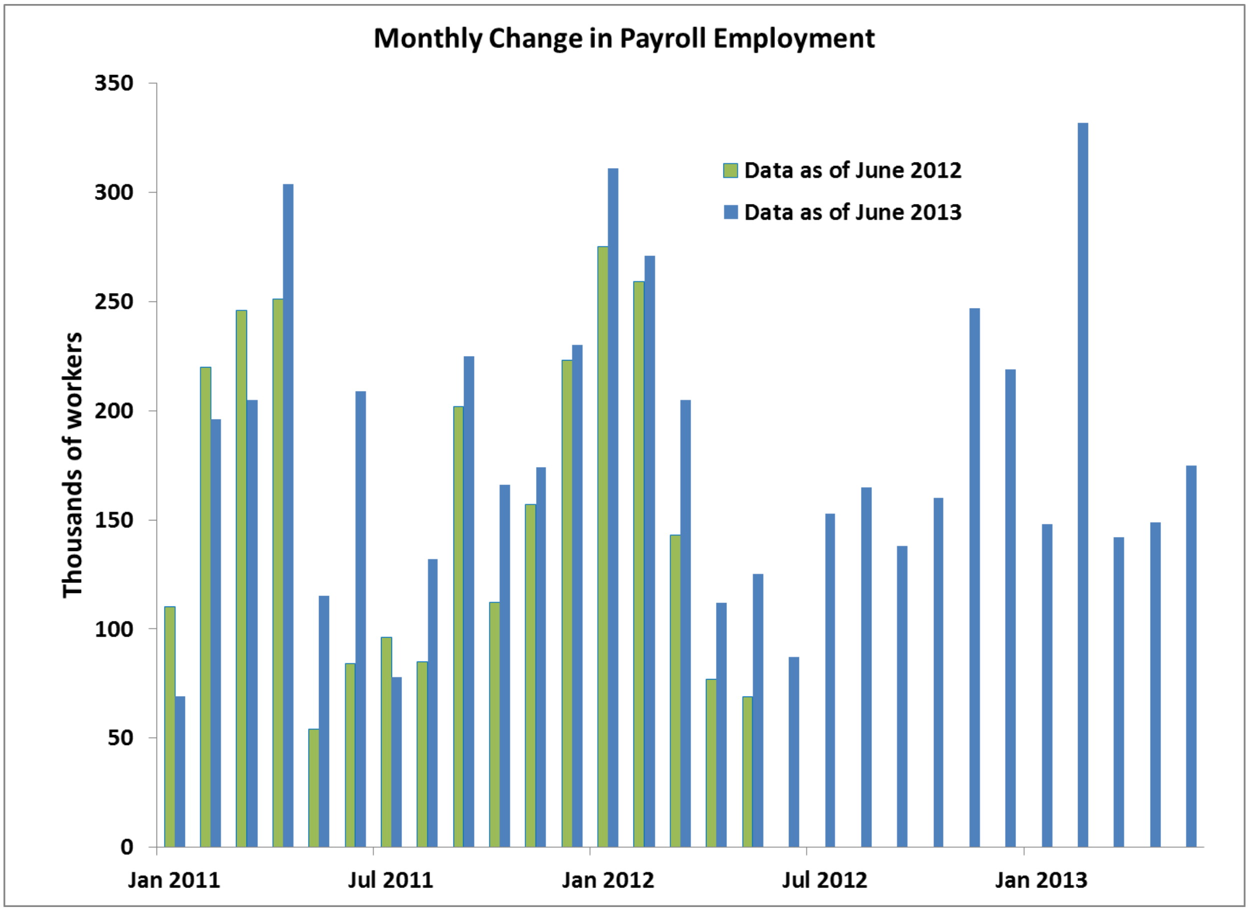

Chart 1. Monthly Change in Payroll Employment. The data show that the labor market was stronger in June 2012 than the Fed thought at the time, as the employment numbers were revised up. The labor market continues to grow reasonably well.

What about inflation, which is the only variable the Fed can control in the long run? Here, the latest data actually show that the financial markets have it all wrong. Inflation is declining, not rising, which means that the Fed is likely to delay implementing its exit strategy and buy bonds in the market even longer than it would have otherwise.

Chart 2 shows the inflation rate based on the 12-month percentage change in the core PCE price index, which is the Fed's main inflation gauge. As in Chart 1, the green line shows data on the inflation rate from one year ago, and the blue line shows the data today. The revisions to the inflation rate, that is, the difference between the green line and the blue line, are not as substantial as the revisions to payroll employment.

In Chart 2, the black line at 2 percent shows that Fed's inflation target. There are lines at inflation rates of 1 percent and 3 percent, which show the upper and lower ranges of what may be the Fed's tolerance ranges for inflation. Although the Fed is not considered to be engaged in what economists term "inflation-targeting," it often behaves as if it does. In an inflation-targeting country, the central bank sets a range for the level of inflation that it will target, such as 1 to 3 percent. As long as inflation remains within the range, the central bank will not try to move it substantially. But once inflation moves outside the range, the central bank will take clear action to move it back into the range. You might notice that in late 2010, inflation moved outside the range of 1 to 3 percent, and that is precisely when the Fed began QE2. With inflation now just above 1 percent, the Fed may soon need to take action to ensure that inflation does not get too close to zero. That is why James Bullard, president of the Federal Reserve Bank of St. Louis, dissented at the meeting. He wanted the Fed to be more clear that it would not tolerate a very low rate of inflation, which is a clear danger.

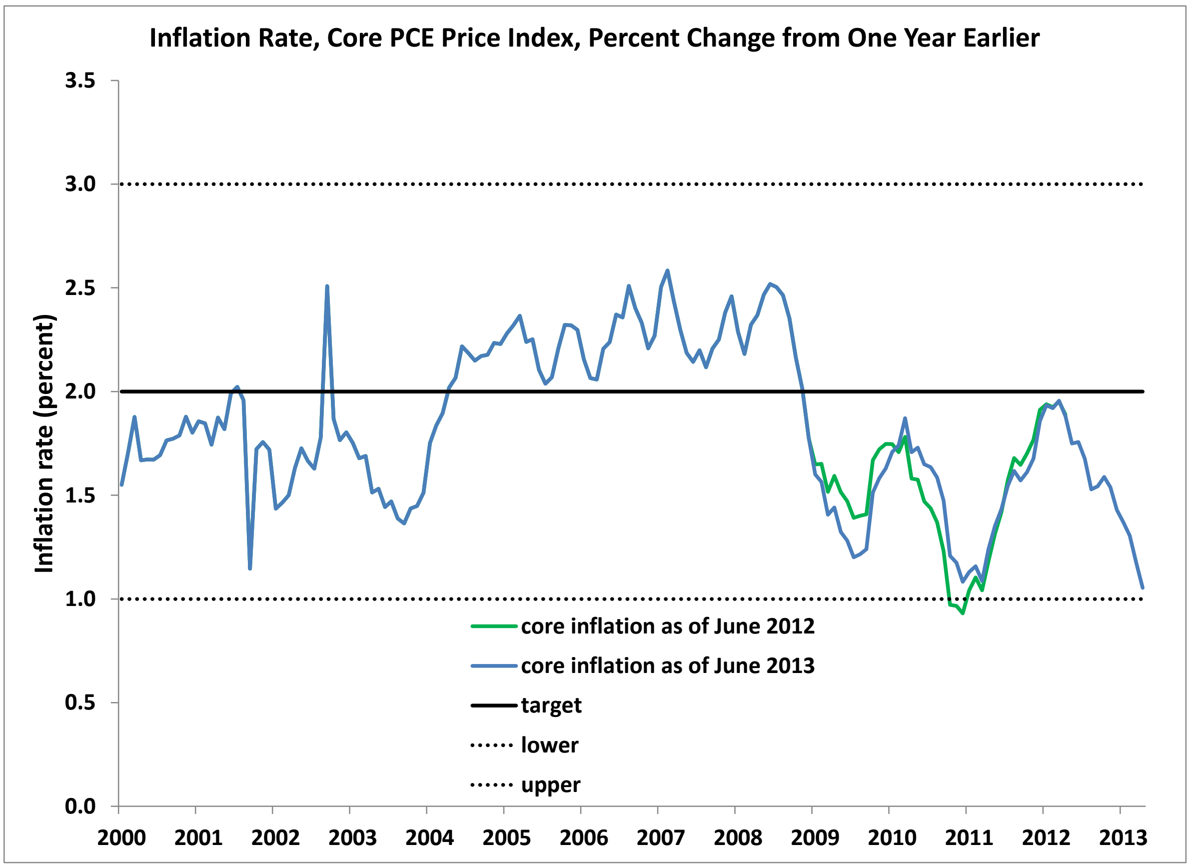

Chart 2. Inflation Rate, Core PCE Price Index, Percent Change from One Year Ago. The inflation rate in 2013 is close to 1 percent, near the bottom of what may be the range the Fed sees as tolerable. Data revisions to inflation were not large or significant, unlike the case for payroll employment.

So, where does this leave us? The economy today is getting better at a slow pace. The labor market shows signs of steady improvement and is certainly in much better shape than we thought it was one year ago. But with inflation declining near the bottom of what may be the range the Fed is willing to tolerate, it seems like the prospects for the future are for additional quantitative easing, not less quantitative easing as the financial markets seem to fear. However, uncertainty about exactly where the economy is headed may have led to investors to sell off financial assets in the short run. In the long run, they may regret that decision.