November 5, 2013

Quantitative Easing Continues

The October meeting of the Federal Open Market Committee (FOMC) had the widely expected outcome that the Fed did not reduce the amount of quantitative easing it has been engaging in. The Fed had decided to continue to purchase $85 billion of securities in the open market each month in September, when it had a vigorous debate about the issue. The Fed surprised the markets at its September meeting by not tapering (i.e., not reducing the amount of securities it bought each month). The Fed’s September decision was based on the facts that fiscal policy was becoming contractionary and that interest rates had risen, which was causing the economy to slow. Because of the shutdown of the federal government in October, the Fed had very little additional economic data at its October meeting, so the outcome of its October meeting was never in doubt.

Will the Fed consider tapering at its December meeting? Perhaps, but it will have to think about its strategy because the December meeting will be Ben Bernanke’s last meeting as chairman. The Fed might find it desirable to wait to begin tapering until Janet Yellen takes over the reins in January, assuming that the Senate confirms her nomination.

One of the macroeconomic surprises that we have been witnessing is the very low inflation rate, despite the vastly pumped up monetary base. As Chart 1 shows, the inflation rate (based on the overall PCE price index) and the core inflation rate (based on the PCE price index excluding food and energy prices) is very low, well below the Fed’s long-run target of 2%.

The figure shows the Fed’s long-run target of 2% as a solid black line. It also shows dotted lines at 1% and 3%, which represent reasonable tolerance bands for inflation around its target. Such tolerance bands are explicit in countries that have formally adopted inflation targeting, as described in M&B, Chapter 18. In the United States, because the Fed has not formally adopted the strategy of inflation targeting, such tolerance bands are not explicitly stated. But based on the discussion at the FOMC meetings and statements by FOMC participants, it is not hard to see that such tolerance bands are implicit in the FOMC’s deliberations.

You can see in the figure that the overall inflation rate has periodically gone outside the tolerance bands, thanks mainly to sharp increases and decreases in energy prices. Because energy prices are so volatile, the Fed mainly looks at the movement of core inflation, which excludes food and energy prices. From the figure, you can see that the most recent data show the core inflation rate barely inside the tolerance bands, standing at 1.2%. This is worrisome to the Fed, as it suggests that the United States is facing similar circumstances as Japan has faced over the past 20 years, with low growth and very low inflation. In fact, the deflation in Japan may have been a key cause of their economic problems in that period, as discussed in M&B, Chapter 16.
The inflation rate, measured using both the overall and core PCE price index, has been below the Fed’s target of 2% most of the time since 2009. So, what will the Fed’s next move be? Economic growth remains slow and inflation is near the lower end of its tolerance band. In such circumstances, tapering quantitative easing does not seem desirable for the Fed. If the Fed tapers by reducing the amount of bonds it purchases each month, it is likely that long-term interest rates would increase, as they did during the summer when the Fed first talked about the possibility of tapering. The higher interest rates would likely slow the economy further by reducing investment demand, which in turn would cause inflation to decline further. Thus, the Fed seems unlikely to taper unless economic growth and inflation both increase.