Monetary Policy Limits: Federal Reserve Actions and Tools

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Tokyo, Japan

May 21, 2012

Key points

- Federal Reserve Bank of Atlanta President Dennis Lockhart says the past few years required resourcefulness by monetary authorities and brought forth unconventional policy actions.
- We are in a phase, Lockhart says, when sustained monetary accommodation is warranted to keep the U.S. economic recovery going.
- Lockhart views communication as a policy tool and believes the FOMC should continue to improve its communications.
- Lockhart does not believe economic circumstances at present warrant another round of large-scale asset purchases known as quantitative easing.

I want to thank the Institute of Regulation & Risk, North Asia for the opportunity to participate in the discussion here this evening. Coming here as a Federal Reserve official rounds out my personal history of visits to Japan. I first traveled here as a tourist on my honeymoon. I later traveled back several times as a private-sector banker. I am now here as a central banker and member of the Federal Open Market Committee (FOMC). That thought triggers my usual disclaimer—my remarks represent my personal views only. My views may not be shared by my Federal Reserve and FOMC colleagues.

We're in a time of slow recovery in my country and recession or very weak growth along with serious fiscal and banking strains in Europe. So it's appropriate that the organizers of this event have presented me with the following question: What more can be done? They have prefaced this question with another: Are there limits to what monetary policy can accomplish?

Question of monetary policy limits

Let me first tackle this question of the limits of monetary policy.

The limits of monetary policy in curing the economic ills that beset advanced economies is a frequent topic these days. This is because—and I speak now more from a U.S. perspective—a lot has been done, yet progress has been quite slow.

The policy interest rate has been at the zero bound since December 2008. We've aggressively expanded the scale of the Fed's balance sheet. Other central banks have grown their balance sheets as well. In these circumstances, it's natural to ask if monetary policy has reached its practical limits in promoting recovery.

The limits of monetary policy might be considered from three angles. First, in very general terms, one might ask if there are inherent limits to what monetary policy can achieve, and are these inherent limits now more obvious? By inherent limits I mean constraints on the scope of effectiveness of monetary policy in solving economic problems in almost all circumstances. For example, as powerful as monetary policy can be, one might argue that it is powerless to cure deep structural problems such as fiscal imbalances or trade imbalances resulting from a lack of competitiveness.

A second perspective on limits might reference statutory or self-imposed limits that central banks observe. These might encompass limits on how far the central bank can or should go in addressing what are fiscal concerns. Monetary policymakers have tried to avoid interventions that put taxpayers at risk of loss. And central bankers have been wary of trying to compensate for policy constraints in other domains of economic and social policy such as workforce development, tax policy, or currency policy.

And finally, the question of the limits of monetary policy could deal with the more immediate and pragmatic consideration of the real or expected effectiveness of current policy and available policy options given the prevailing circumstances in the economy.

Each of these three perspectives has relevance in today's policy context in the United States, but it is this last dimension of the limits of policy that I want to explore in my remarks this evening. The economic conditions of these past few years have required resourcefulness on the part of monetary authorities and evoked unconventional policy actions. Central banks, the Fed included, may have to devise ways to respond to unique circumstances in the future. But for now—based on recent experience—policy actions seem to fall under three headings. They are interest rate policies, balance sheet actions, and communications directed at markets and the public.

Employing three tool sets

The FOMC has employed all three tool sets to address the varied circumstances it faced over the last four years.

As you may remember, the Federal Reserve implemented a series of extraordinary emergency lending measures in the wake of the Lehman Brothers and AIG failures in September 2008. By the end of that year, the target for the federal funds rate had been lowered to its effective lower bound range of 0 to 25 basis points.

Looking back, 2009 represented the year of transition from acute crisis to recovery. Over the course of 2009, the Federal Reserve wound down most of its emergency lending facilities and transitioned to the current mode of conducting monetary policy operations. That approach relies substantially on balance sheet changes. The FOMC has been unable to resort to its familiar short-term interest rate instrument to provide further stimulus to the economy.

The first stages of this new phase involved large-scale asset purchases. These large-scale asset purchase (LSAP) programs are popularly known as QE1 and QE2. This terminology reflects a tendency of referring to policies that have a large impact on central bank balance sheets as "quantitative easing."

I believe that the motivations of the two policy actions were more distinct than the QE1 and QE2 labels suggest.

The first large-scale asset purchase program—so-called QE1—was put in motion by the FOMC in March 2009. The FOMC decided to purchase a total of $200 billion of agency debt, $300 billion of Treasury securities, and $1.25 trillion of mortgage-backed securities issued by the federal housing agencies. Eventually the Fed completed all but the direct agency purchases.

In my view, these purchase programs played an important role in the transition away from the emergency lending facilities created earlier in the crisis. The emergency credit facilities worked well to stem the downward spiral of the immediate post-Lehman period. Financial markets began the process of repair during the first half of 2009 but were still suffering from relatively serious liquidity pressures. The QE1 operation sustained the liquidity support that had been previously provided by lending through the emergency facilities.

Because asset purchases largely replaced emergency loans made during the crisis, the net increase in the Fed's balance sheet was relatively modest. In this sense, the quantitative easing label is misleading. The intent and effect of the policy was not to inject a new and sizable quantity of reserves into the economy. Rather, the effect was to sustain liquidity in still struggling and fragile financial markets, particularly those related to residential real estate. For that reason, I prefer the term "credit easing" to describe this policy action.

I view QE2 differently. The FOMC formally announced QE2 in November 2010, with its decision to purchase $600 billion in longer-term Treasury securities. However, the policy was signaled in an important speech from Federal Reserve Chairman Ben Bernanke in August of that year. The circumstances at the time were dominated by a falling trend in measured inflation, weakening inflation expectations, and rising probabilities of outright deflation. Each of these developments was effectively reversed as the expectations for QE2 took root, expectations that were ultimately validated by FOMC action.

Unlike QE1, QE2 did materially expand the size of the Federal Reserve's balance sheet. In my view, this distinction is important. The intent and effect of the two rounds of asset purchases were different. QE1 served to maintain liquidity at a time when financial markets were exceptionally unsettled. In contrast, QE2 was a more traditional monetary action to preserve price stability.

The latest phase of policy actions involves further balance sheet operations and enhanced and expanded communication.

In August of last year, the FOMC replaced its existing forward guidance on interest rates. Prior to that date, the language indicated only that interest rates were likely to remain at exceptionally low levels for an extended period. This language was replaced in August with more explicit guidance that spelled out the meaning of "extended period." Specifically, at that time the FOMC indicated its expectation that economic conditions would warrant very low interest rates at least through mid-2013. Subsequently, that guidance was updated to late 2014.

In September of last year, the FOMC announced its Maturity Extension Program (MEP), often referred to as "Operation Twist." By next month, this program will have increased the Fed's holdings of longer-term securities by $600 billion matched by equivalent sales of shorter-term securities. At the same time the FOMC announced the MEP, the committee stated its intention to maintain the size of its mortgage-backed securities (MBS) portfolio by reinvesting the proceeds of maturing MBS securities.

In terms of intent and effect, I think of the explicit forward guidance and the MEP in similar terms. We have entered a phase of the recovery in which sustained monetary accommodation is warranted in order to preserve and advance what is still modest progress on employment and economic growth. Importantly, this modest progress is occurring in the context of what, for me, is acceptable performance with respect to our price stability mandate. Actions that reinforce the maintenance of policy accommodation are appropriate. It is through that lens that I view the MEP and explicit forward guidance on policy rates.

Let me summarize this brief tour of postcrisis monetary policy. I view the sequence of nontraditional monetary policy actions as tailored responses to the particular needs of the economy and financial system at the time they were implemented. My conclusion is that by and large policy actions have been appropriate to the diagnosis of circumstances at the time. And in my assessment they have worked pretty well.

Today's economy

Circumstances today in the United States call for continued measured efforts to quicken the pace of recovery and shrink unemployment, while keeping inflation controlled and close to the FOMC's official target of 2 percent. Those efforts for the time being should fall in the realm of communications. Current economic data continue to be a mix of positives and negatives. Consumer activity is continuing to grow, and manufacturing is expanding. At the same time, we've seen a recent slowdown in business investment, and the pace of job creation has weakened.

My economic outlook calls for only modest growth over the next few years.

The modest recovery and associated slow job growth is keeping wage growth subdued and inflation expectations reasonably well-anchored. As a result, my outlook for inflation remains steady at around 2 percent over the forecast horizon.

There are larger-than-normal risks to my outlook, however. Chief among them is the potential for broad spillover from Europe to the U.S. and global economy resulting from financial system disruption as well as further economic slowdown.

For this reason in particular, I currently judge the risks to the U.S. outlook as tilted modestly to the downside.

Central bank communications

To repeat my earlier assertion, I think use of the tool of refined communication is an appropriate incremental policy action.

It's useful, I think, to conduct a thought experiment about central bank communication. Let's consider what constitutes perfect communication. I would argue that communication approaches perfection when the broad, attentive public understands how the monetary authority is going to behave. Put differently, there would be near-perfect certainty about the monetary authority's reaction function under all circumstances.

In this imagined world, consumers, businesses, savers, and investors can make appropriate adjustments to their decisions and behaviors as each indication of the economy’s trajectory becomes known. They can do so because they have certainty about what the policy reality will be. In this world, communication promotes the efficient functioning of financial markets. Risk premiums come down and rates are lower than they otherwise would have been. Both markets and individuals can be confident policy surprises won’t complicate outcomes. And with that confidence and certainty, the mutually reinforcing roles of economic agents and policymakers become tightly synchronized in a causal loop.

In my view, working toward this end is the right undertaking of the FOMC at this moment, even if it is not fully achievable. The FOMC should continue to clarify its strategy for the medium and long term so that the public can discern how the committee arrives at decisions. In that vein, effective communication that results in the public knowing the extent of uncertainty policymakers face also helps.

Institutional constraints of central banks can have a significant influence on how far a central bank can go in perfecting communication. The FOMC, for example, is made up currently of 12 voting members with another seven of the Reserve Bank presidents participating without a formal vote at any given point in time. The differences of perspective around the table are substantial. I would argue that the FOMC was designed to achieve a consensus on the monetary policy decision if not the supporting analysis. Put more simply, achieving consensus around a decision is a lot easier than arriving at a consensus forecast or a uniform position on how policy should react to hypothetical future developments. Still, I believe the FOMC should continue to work on improving communication methods. At the moment, it is a work in progress.

In closing, I have reframed to some extent the original question of what more can be done around the point that policy actions must be matched to circumstances. The challenge policymakers face is judging appropriateness of a tool for circumstances. As popular as it might be in some quarters to rule out further LSAPs (QE3, as it is known), I do not think this option can be taken off the table. QE3 will work under the right circumstances. But I don’t believe such circumstances prevail at this time.

Thank you.

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