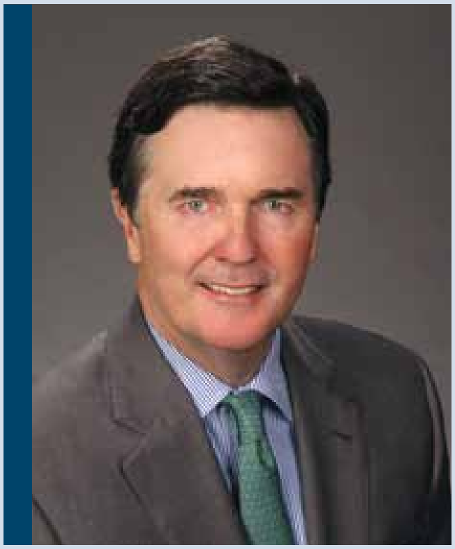
Fed @ Issue

Bringing Perspective to Recent Policymaking



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On Nov. 3, 2010, the Federal Open Market Committee (FOMC) announced a policy decision to conduct further purchases of Treasury notes over the coming eight months, with these purchases accumulating up to $600 billion.

This policy has come to be known as *QE2*. The QE stands for *quantitative easing*, and the "2" represents a second round. At a technical level, I don't think this is the best term for the policy. The term quantitative easing is best reserved for a policy that operates primarily through the expansion of bank reserves. The November 3 action is not expected to work through that channel. Rather, the policy is expected to work mostly through other transmission mechanisms in financial asset markets. In my view, the Fed's current policy is more in the spirit of its 2009 large-scale asset purchase program (LSAP), which at the time was described as *credit easing* to distinguish it from a policy aimed at broad money growth.

I supported the policy decision in the deliberations of the FOMC on November 2 and 3. This policy is designed to further improve financial conditions and thereby support a faster recovery, reduce the potential of deflation, and accelerate the eventual achievement of the Fed's two statutory mandates—maximum employment and price stability.

The Fed's large-scale purchases of Treasury securities can stimulate the economy through various channels, the main one being asset prices. Increased demand for Treasury securities should bring down their yields. In search of higher yields, private investors will buy stocks, bonds, and other assets, and prices of those assets will rise. Higher asset prices will make people feel better off and should lower borrowing costs, thus encouraging households to consume and businesses to invest.

The FOMC's decision to purchase additional assets has been controversial both here in the United States and abroad. There are four major views that critics of the policy seem to hold: the Fed is monetizing the federal debt; the Fed is purposefully devaluing the dollar; the policy is unconventional, with unknown risks, and may create serious unwanted inflation; and finally, this additional easing simply won't work.

CONTINUED ON PAGE 39

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Editor's note: Throughout this issue, Southeast refers to the six states that, in whole or in part, make up the Sixth Federal Reserve District: Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee.

Photos on pp. 20-23, 26, 28, 32, 34, 36, and back cover (right) courtesy of the Library of Congress photographic archives

CONTINUED FROM PAGE 1

Addressing monetization concerns

A policy of monetizing debt would be most properly understood as a policy in which the Fed ties its purchases of Treasury securities to new debt issues by the Treasury. In this situation, the intent would be to enable the government to finance near-term deficits, eventually inflate away some of the nominal value of government debt, or both. This is *not* the objective of the Fed's November decision.

In my view, the current policy is designed to support the expansion of the economy and to maintain inflation near the FOMC's desired objective for price stability. Although not explicit, this objective is understood to be a level of core CPI of 2 percent or lower. I have every confidence the policy will revert to reducing the size of the Fed's holdings as those conditions are met.

I feel it is particularly important to understand that the FOMC's purchase program is conditional and will be evaluated in light of developing economic conditions. When conditions warrant, these purchase operations will cease, and eventually sales will be instituted. I am confident these decisions will be made independent of fiscal considerations.

Preserving the value of the dollar

It has also been argued that the Fed's asset purchases have the intent—and also the effect—of devaluing the dollar. As I see it, there is no monetary policy intent to engineer specific values—or even a direction—for the dollar. In other words, this policy was *not* undertaken to prompt dollar depreciation.

Prices of many types of assets are affected by monetary policy actions. The monetary transmission mechanism works by altering the relative price of various assets. The effectiveness of the policy will not hinge on dollar depreciation and, therefore, the price of the dollar in foreign exchange markets.

For those concerned about the dollar's value, I believe it is important to stress that the most critical factor in maintaining the dollar's value is a strong economy with stable inflation. It is true that the short-term effect of the Fed's policy put some downward pressure on the dollar for a time as markets reacted to the prospects of lower interest rates for a longer period and less risk of deflation. But the purpose of the policy is to strengthen the U.S. economy, which is in the world's interest.

Avoiding unwanted inflation and other risks

A number of people have raised a third concern: namely, that this approach is new and unconventional and fraught with risks that are going to harm the economy over the longer term.

It's true that a large-scale asset purchase program is an unfamiliar policy in the sense that we are not targeting the federal funds rate. And I acknowledge there is uncertainty associated with this policy approach as compared with fed funds rate targeting. Much of that uncertainty revolves around scale and lags—how large do the purchases need to be to have a noticeable effect? And how quickly will we discern that effect? In my mind, the perceived risks—particularly the risk of overshooting inflation—must be weighed against the risks that could be associated with a policy of inaction. Chief among those risks is a recessionary relapse possibly tipping into a long spell of deflation. Through the summer there were some signs of renewed disinflation, which could have led to deflationary expectations taking hold. This did not happen.

I believe it is important to stress that our experience in dealing with inflation versus deflation is not symmetric. In the event of a policy overshoot, inflation containment requires the implementation of the mostly familiar strategy of raising short-term interest rates. In the event of an undershoot, however, dealing with a deflationary spiral and the attendant real consequences would be far less familiar territory for policymakers.

Will it work?

A final criticism levied against the asset purchase program is that it will fail to foster economic growth and price stability—that is to say, it won't work. It's important, I believe, that we be measured in our expectations about how much more stimulus can accomplish in the current environment. I don't have outsized expectations. I see it as a precaution aimed at reducing or eliminating downsides. I also see it as an insurance against deflation.

Further, in terms of near-term economic activity, I see the additional asset purchases as buttressing the ongoing effects of policies that have already been put in place. I expect it should have some incremental positive effect on overall demand. With regard to price stability, this policy has already shown some signs of success by altering inflation expectations and reducing the risk of unwanted disinflation.

Managing inflation expectations requires following through with policy actions consistent with stated objectives—in this case, ensuring that inflation trends remain in a desired zone. The FOMC's November decision should be seen in that light. ∎

This article is adapted from a November 2010 speech by Dennis Lockhart.