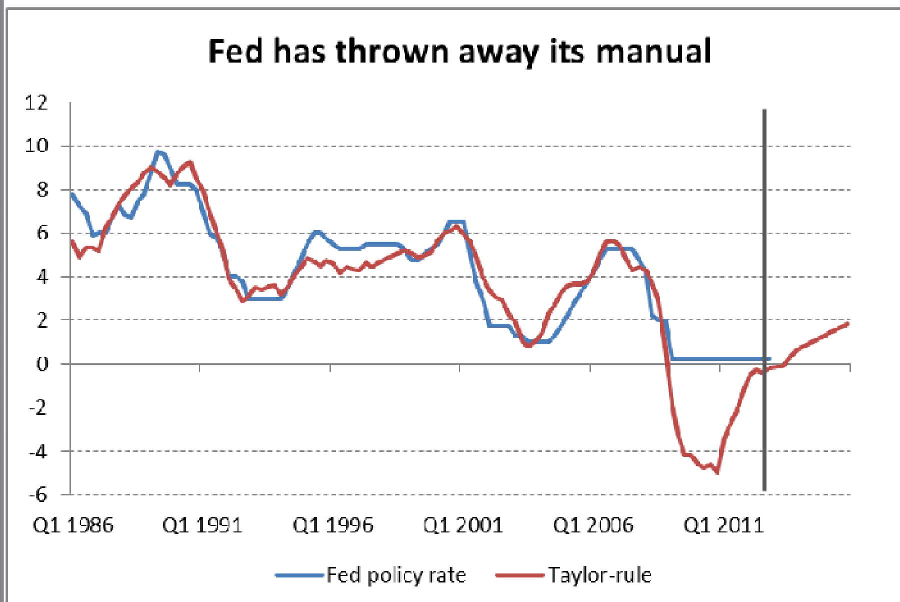
Fed looking for the exit

21 February 2013

Against the backdrop of increasing signs of economic recovery, the Fed has started to look for the exit for its unconventional monetary policy. After already discussing the end of its QE-program at the December meeting, it continued along these lines during the end-of-January meeting. On the current economic outlook the Fed is likely to stop buying assets this year. Actual rate hikes or actively selling some of the assets on its balance sheet are still a long way off. However, current market expectations of no rate hikes before 2015 are unlikely to hold. Economic recovery and increasing inflation risks will force the Fed to move earlier.

Throw away the old policy manual

In the past two years, the Fed has thrown out its monetary policy manual. From the mid-80s to about two years ago, Fed policy could be perfectly explained by a simple Taylor-rule, which relates monetary policy to unemployment and inflation. In the 2008-09 crisis this model suggested that the dismal state of the US economy warranted a negative interest rate. In practice the Fed managed this via its quantitative easing (QE) operations. However, this model also suggested that starting in 2011 the Fed should already have been taking back some of its unconventional stimulus measures. In reality the Fed did the opposite and continued adding stimulus. The model suggests that by now the Fed should have unwound most its QE and should be thinking about raising its policy rate in the very near future. On the assumption of stable core inflation and a gradual decline of the unemployment rate (easing to 6.5% by the end of 2015), the old Fed reaction function suggests a first rate hike before the end of this year.



The Fed has clearly moved away from its traditional model. It has just started to discuss the end of its QE-program. Rate hikes or actively reducing the balance sheet are still very far away. By breaking away from its usual model the Fed is clearly aiming for higher inflation. At some point in time, the Fed will be successful in this. As the economy recovers, this policy stance will become increasingly uncomfortable. Printing money will generate inflationary pressures eventually, but only after that money actually reaches the economy (via the credit channel) and that economy is operating at capacity. The US is getting closer to this point, but is not there yet. Credit growth is picking up, but from low levels. Moreover, the economy is still quite far from operating at capacity. Total employment is still 3.2 million jobs below its level at the start of 2008. This suggests there is still enough slack in the economy to keep inflationary risks in check for quite some time. Nevertheless, as the recovery progresses, the inflation risk will become more important.

Nearing the end of QE

Even as the Fed increased its QE-program in December (to compensate for the end of Operation Twist), it has been discussing the end of that program. This was confirmed by the minutes of the December meeting. During the January meeting, the Fed continued along those lines.

- December: 'several participants wanted to slow or stop purchases before the end of 2013'.
- January: 'many participants also expressed some concerns about potential costs and risks arising from further asset purchases' and 'a number of participants stated that an ongoing evaluation … might well lead the Committee to taper or end its purchases before … a substantial improvement in the labour market outlook'. However, 'several others argued that the potential costs of reducing or ending asset purchases too soon were also significant'.

In all, the January minutes just showed a further small step in the direction that was already outlined in the December minutes. If the economy continues to recover in line with current expectations, the Fed is highly likely to gradually reduce asset purchases throughout the year, which should see an end to the program by the end of 2013. The overall tone of the minutes suggests a lot of caution in this process, an aggressive policy change is definitely not on the cards for now. Even though the Fed is already behind its usual reaction function, it still seems far more inclined to wait too long rather than act too soon in reducing monetary policy.

Key issues on the Fed

- The Fed is clearly taking a risk on higher inflation, rather than risk hurting the recovery. In a medium term perspective this significantly raises inflation risks (even if these are likely to remain limited for quite some time).
- The first step towards a change in monetary policy will be a reduction in, and eventually the end of monthly asset purchases. On the current outlook this should be expected in 2013.
- To limit the effect of the change in monetary policy, the Fed is likely to continue to adapt its wording to prepare markets for what's coming. They will not risk shocking markets like they did in 1994.
- Any change in monetary policy will be gradual and in line with the economic recovery. If the latter should falter, the Fed could rapidly move back to more stimulus.

Impact on financial markets

Earlier turns towards tighter monetary policy in the US (in 1984, 1994, 1999 and 2004) had a negative impact on financial markets. Both bond and equity markets suffered initially, although equity markets recover rapidly as the recovery driving the monetary tightening makes itself felt. Following the initial rate hike of the earlier tightening cycles, S&P500 was down in the first three months (3.5% on average), only to recover strongly in the next three months (up 7.3% on average).