



## Something Old, Something New, Something Borrowed and Something 2

The last meeting of Federal Reserve policymakers created quite a stir. When trying to understand how that meeting may affect markets going forward, it is useful to think of the central bank's latest pronouncements as extending something old, introducing something new, adopting something borrowed – and agreeing on “something 2.”

The Fed took four noteworthy decisions at its late January meeting: The Fed explicitly extended the length of time that it expects interest rates to remain “exceptionally low” and kept the door open to adjusting at a future meeting the size and composition of its balance sheet (something old); it reached unanimous agreement on a published numerical inflation target (something borrowed) of 2% that, in its judgment, best satisfies its mandate to achieve price stability; and for the first time (something new) it published Federal Open Market Committee (FOMC) members' individual forecasts of the federal funds policy rate expected to prevail in each of the next three years as well as in the “long run.” Each of these decisions merits further examination.

In its customary prepared statement released at the conclusion of its two-day meeting, the FOMC changed its expectation of the date until which it expects to keep the policy rate exceptionally low, extending it from the mid-2013 horizon announced in August 2011 to “at least through late 2014.” In particular the statement said (with emphasis added here and in subsequent quotes):

“The Committee expects to maintain a highly accommodative stance for monetary policy. In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and *currently anticipates that economic conditions* – including low rates of resource utilization and a subdued outlook for inflation over the medium run – *are likely to warrant* exceptionally low levels for the federal funds rate at least through late 2014.”

## “So now it’s official: the Fed is an inflation targeter.”

Note carefully the wording in the statement as it refers to the “anticipation” today by the FOMC that “economic conditions are likely to warrant” this accommodative stance for policy for nearly three more years. As written it is *not a commitment* by the Fed to keep the funds rate anchored at 25 basis points regardless of incoming data, but is instead a message that the Fed expects inflation and unemployment rates through late 2014 will warrant this policy. That said, this and similar previous FOMC statements are explicit examples of the Fed’s “forward guidance” strategy, which seeks to reduce yields on long maturity government bonds by, at minimum, influencing the perception in the markets of both the increasing probability and longer timeframe for the Fed’s policy rate to remain at the zero lower bound. And for some members of the FOMC – district bank Presidents Lacker, Plosser, Fisher and Kocherlakota – this goes too far. Each when given the opportunity has voted against this manner of forward guidance, feeling that it certainly implies, even if it does not specifically state, that the Fed is committed to keeping rates on hold until some specified date in the future.

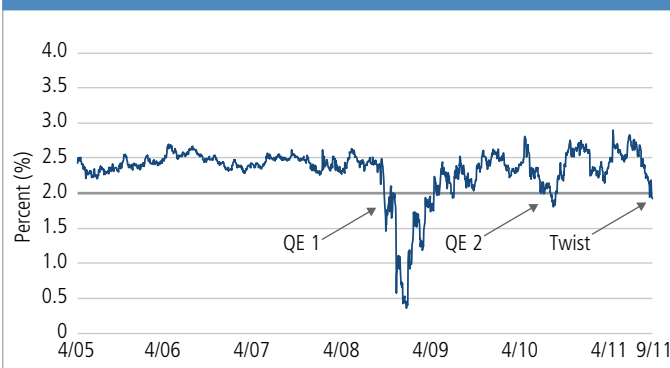
The statement also kept open the door to an additional round of quantitative easing (QE), although it did not suggest QE3 is imminent:

“The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in a context of price stability.”

Taken literally, this statement does not rule out the Fed adjusting the size and composition of its balance sheet to tighten policy by selling Treasuries and mortgage-backed securities (MBS) from its portfolio holdings. But in the context of its assessment that the Committee “expects to maintain a highly accommodative stance for monetary policy,” any adjustments to its balance sheet would very likely be to expand the balance sheet and change the composition by directing new purchases to MBS as advocated, for example, by Governor Tarullo.

As for the timing of a possible future QE3, as I wrote in October 2011, what’s past may be prologue. The Fed, for example, has embarked on two rounds of QE – in November 2008 and November 2010 – and one round of “Operation Twist” (selling short-term Treasuries in exchange for longer-term debt) in September 2011. A striking correlation exists between one of the Fed’s preferred measures of the public’s long-term inflation expectations – the five-year forward breakeven inflation rate five years in the future – and the timing of a QE or twist program (see Figure 1). To date, since Fed rate cuts drove the policy rate down to the zero lower bound, there have been exactly three times when the five-year forward breakeven inflation measure five years in the future has fallen below 2%, and in each instance the Fed announced a QE or Twist program soon thereafter. This correlation is not a coincidence. The Fed’s mandate is to deliver price stability, which means avoiding deflation and keeping inflation expectations well anchored. As market expectations of forward inflation five years in the future drift below 2%, and with the Fed unable to lower the policy rate because of the zero lower bound, it has chosen to stabilize expectations via these quantitative programs. While the cost-benefit calculus behind these programs is a subject of much debate, their timing and purpose should not be. It would seem that, at minimum, the FOMC is most likely to be in agreement that QE3 will be warranted if it is falling short on both sides of its dual mandate to achieve price stability and maximum sustainable employment.

Figure 1: Five-year, five-year forward breakeven inflation below 2% predicts timing of QE/ Twist Operations



Sources: PIMCO calculations, Bloomberg. Data as of 3 October 2011.

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As for the dual mandate, the Fed on January 25 significantly clarified and made public an agreed-upon framework detailing how it aims to satisfy the mandate in the long run. Here are the key passages:

“The inflation rate over *the longer run* is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee judges that *inflation at the rate of 2 percent* as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve’s statutory mandate.

“The maximum level of employment is *largely determined by nonmonetary factors* that affect the structure and dynamics of the labor market. These factors may change over time ... estimates of *the longer-run normal rate of unemployment* had a central tendency of 5.2 percent to 6.0 percent, roughly unchanged from last January but substantially higher than the corresponding interval several years earlier.”

Importantly, the design of the framework is intended to serve as a guide to Fed policy not only at present, with rates at the zero lower bound and with its balance sheet swollen by its QE programs, but in the future when the Fed is raising interest rates and shrinking its balance sheet. The key elements of the framework are a published and *unanimously agreed upon* inflation target (technically “goal”) of 2% in “the longer run,” and the FOMC’s estimate that the long-run normal rate of unemployment should be in the range of 5% to 6%. The published dual FOMC forecast that headline inflation is expected to fall below 2% in 2012 and remain there through at least 2014 *and* that the unemployment rate will remain above 6%, the upper range of its estimate of long-run normal unemployment, underpins the justification for a status quo policy package of keeping the policy rate at the zero lower bound, continued forward guidance and, possibly, a future round of QE.

However, the topic that generated the most discussion among Fed watchers after the January meeting was the widely anticipated decision to begin to publish FOMC members’ individual forecasts of the federal funds policy rate. However, the forecasts are for the rate each member would expect to prevail under his or her own economic forecast and according to the member’s own judgment of optimal policy in each of the next three years as well as in the “longer run.” Importantly, these forecasts *are not* a forecast of what the Fed policy rate *will be* but, rather, what each member believes it should be. As I tell my sons: I *would like* to play shortstop for the Yankees, but I *predict* that Derek Jeter, not me, will be in the lineup on opening day. Three FOMC members have indicated they would personally want the Fed to begin hiking rates by year-end 2012, yet it is very likely that none of these three actually expects the FOMC will actually be voting to hike rates by year-end. As such, while the publication of these forecasts is a move in the direction of greater transparency, the current approach may need to be refined in the future. For instance, the other central banks who publish policy rate forecasts (New Zealand, Norway and Sweden) publish a forecast of the policy rate that is expected to prevail given the bank’s forecast of economic conditions and (presumably) a consensus on appropriate policy conditional on this forecast.

So now it’s official. The Fed is an inflation targeter. More specifically, the Fed is an inflation *forecast* targeter and seeks to deploy policies that will deliver 2% inflation over the longer run, which it deems to be a period of “perhaps 5 or 6 years.” Given the Fed’s targets for both inflation and long-run normal employment, the new framework suggests continued lower bound rates, forward guidance and potentially additional QE. What the new framework does not do, yet, is to lay out how the Fed will make the trade-off in the future if its inflation and employment objectives are in conflict. If the FOMC forecast for headline inflation falls and stays below 2% in 2012, and the 2014 forecast is proven correct, there will of course be no conflict between the dual mandate objectives over the next several years. But this is a conflict – or trade-off – that has only been deferred to the future, and the January 25 framework agreement does not articulate

how the Fed would navigate such a conflict. It seems inevitable to us the Fed will in the future face, as the Bank of England recently faced, a situation with inflation above target, and forecasted to remain for some time above target, but with unemployment above the long-run normal rate. At that point, if not before, I suspect the Fed will refine the January 2012 framework to communicate more clearly how future conflicts between their dual mandate objectives will be approached.

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