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Constrained Monetary Policy: the FOMC Statement of 9 21 2011 and the Wages of Fear

The Bernanke Fed, and the FOMC that is its official policy organ, has focused on increased transparency. Sadly, transparency doesn't equal comprehension. The FOMC policy statement today becomes harder to understand the longer one reads it. The statement tells us that the Fed is going to undertake a $400 Billion dollar balance sheet shift, but leaves it to the reader to figure how this shift is going to make financial conditions easier for the U.S. economy. It will be several weeks before the Minutes of the meeting are released, and even then, the various views on how monetary policy operates that will be expressed in the Minutes will not give Fed Watchers a full understanding of how the Fed conceives of its policy options and how members think monetary policy works in the current macro-environment.

Market views of what the Fed was likely to do focused on '**operation twist**,' an attempt to hold the Fed's balance sheet constant but transform the maturity structure of its holdings. The Fed **"today decided to extend the average maturity of its holdings of securities. The Committee intends to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less."**

Second the Fed "**will now reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. In addition, the Committee will maintain its existing policy of rolling over maturing Treasury securities at auction."**

The market was somewhat surprised by the **size of the balance sheet** ($400 billion) shift that the Fed wishes to undertake between now and the end of June 2012 and it was further surprised by the extended maturities that the Fed seeks to purchase. It is unlikely that the market was surprised by the Fed's attention to agency debt and agency mortgage backed securities.

Some commentators (including this one) had conjectured that the Fed would throw a fillip to critics who have questioned whether paying even a nominal 15 basis points to member banks that hold excess reserves on deposit at the Fed was either productive or "fair." The FOMC didn't venture into that thicket.

How did the FOMC get to this position? What does the Committee envision as the monetary transmission mechanism that will translate this policy into easier financial conditions? And, what is the quantitative relationship that the FOMC has in mind that allows it to select the $400 Billion amount over the specified nine month policy horizon? None of these questions receives explicit treatment in the FOMC statement released today. We are dubious as to whether the forthcoming

Minutes will enlighten policy analysts. The context of the Bernanke led policy is clear. He sees very limited options available to the Fed and expects the Congress to 'do its duty' when it comes to setting an appropriate fiscal policy. That he told us with his speech at Jackson Hole at the end of last month. Apparently, he didn't convince the rump dissenters, Fisher, Kocherlakota or Plosser who had voted against the FOMC's last statement in August. It is the substance of that difference of views that should concern policy analysts. First, start with the FOMC's views of the current economic situation.

The first two paragraphs of the statement that describe the current environment highlight labor market weakness, modest household spending, weak investment in non-residential structures and moderating inflation concerns. But the second paragraph contains a ticking bomb. "**Moreover, there are significant downside risks to the economic outlook, including strains in global financial markets**." And we already have learned of the immense Swap program the Fed has authored with the ECB to allow the ECB to fund dollar demands by banks in Europe.

The market apparently read that sentence as a growing probability of a **double dip** recession and plummeted after the 2:15 pm statement, as well as the earlier in the day Credit Downgrades of BofA, Citi and Wells Fargo. The Credit Raters justified their downgrades with a suggestion that the US Government might not be sufficiently friendly to possible future support needs of these members of the 'too big to fail' club. After Lehman, it seems a bit of a stretch to think that the authorities would allow the collapse of any of these three, but clearly the Credit Raters are on the defensive for their lack of due diligence in rating mortgage securities during the housing boom. There is nothing like a reformed drunk to preach against the evils of alcohol!

Meanwhile, what theory drives the FOMC doves to think that a) Operation Twist will be successful? (b) that they have pegged the right amount of balance sheet transformation? or (c) that by weakening the earnings power of financial intermediaries by depressing the longer end of the rate spectrum they will induce more credit to the private sector? Isn't this the same 'old view' that pushing interest rates down is a remedy for any macro ailment that has not been given much empirical support in this recession and blunted recovery? If lower interest rates were the general balm that lies behind current and prior Fed policy, there has to be much 'ad hocery' in their current macro theory---either that or they must think that loan demand only depends upon interest rates? The 'lost decade" of Japan---notwithstanding ZIRP---must have some special explanation to these FOMC doves—and that must fall in line with how ineffective low or zero interest rates has been in expanding commercial loans?

Another view, is of course, that "fear" and immense "uncertainty" by both financial intermediaries and by potential borrowers in the household and business sectors, lies at the root of the observed lack of loan growth and build up of heavy corporate cash balances. If these fears lie at the root of the tempered response to low interest rates, how does pushing the long end of the curve resolve that fear? Moreover, explicit citation that the current situation can be more serious than the Fed has been willing to admit is not going to be a magic elixir either! One can't help thinking that the current policy statement is almost a confession of impotence that the market is going to use to trash equity values even further. Fed induced uncertainties make this Fed the handmaiden of the current Administration that on the one hand attempts to cast more Manna on a starving economy and at the same time trash financial intermediaries for past sins. Both are ‘environmentals’ more likely to promote fear and uncertainty and highly unlikely to convince corporate CFO’s that their current policies of hoarding cash and modest investment expansion are wrong. By stretching the program to end June, 2012, the Fed is also hinting that it is going to get out of the business of financial ease during the run-up to the November Presidential election. It is a bit much to think that the promiscuous balance sheet policies of this Fed will be turned into prudent virtue by a withdrawal during a critical election period.

One cannot blame the Fed for the continual thrashing of business pursued by many agencies of this Administration. Undoubtedly, Bernanke cringes every time he sees the DOJ or the NLRB or the EPA throw more gasoline on the fires of fear that constrain business sector expansion. Unfortunately, however much the Housing Sector Cheerleaders will feel better that the Fed is still in there pitching on expanded housing credit, this Administration has no real policy of ‘fix the mortgages’ that can work. Further, these Cheerleaders were the same ones who told the GSE’s to support lending with abandon to anyone who came in the door during the Housing Boom. They were the much-faulted co-conspirators of the Credit Raters. Who will believe them now?

We have learned one thing from this Bust and the policies that seek to treat it: a policy of artificially low interest rates can only work in an economic environment of confidence. When key economic agents are fearful of future regulatory and tax and expenditure policies, ‘uncertainty’ overwhelms a narrow discounted present value approach to business investment that is optically enhanced by the promise of low future interest rates. Further, by trashing financials over the last three years, credit officers have been scared silly. They have derived a single lesson: Keep your powder dry and store up as much of it as you can.

If interest rate policy is to work, the investment environment has to be changed drastically---and that is not the Fed’s mandate nor does the Fed have more than marginal influence in creating confidence. These policy moves hardly bring a more conducive investment environment closer. This is a fear-inspired and a fear-inspiring policy response. If it doesn’t work, and the likelihood of its working is low, confidence in the Fed will shrink even more. If there is a revolution in November of 2012, the Fed’s vaunted independence is going to be on the chopping block. The Fed wasn’t designed as a political institution—but it is increasingly being viewed as one with some justification.

FOMC Statement 9 21 2011

Information received since the Federal Open Market Committee met in August indicates that economic growth remains slow. Recent indicators point to continuing weakness in overall labor market conditions, and the unemployment rate remains elevated. Household spending has been increasing at only a modest pace in recent months despite some recovery in sales of motor vehicles as supply-chain disruptions eased. Investment in nonresidential structures is still weak, and the housing sector remains depressed. However, business investment in equipment and software continues to expand. Inflation appears to have moderated since earlier in the year as prices of energy and some commodities have declined from their peaks. Longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee continues to expect some pickup in the pace of recovery over coming quarters but anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Moreover, there are significant downside risks to the economic outlook, including strains in global financial markets. The Committee also anticipates that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate further. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.

To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, the Committee today decided to extend the average maturity of its holdings of securities. The Committee intends to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less. This program should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

To help support conditions in mortgage markets, the Committee will now reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. In addition, the Committee will maintain its existing policy of rolling over maturing Treasury securities at auction.

The Committee also decided 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 mid-2013.

The Committee discussed the range of policy tools available to promote a stronger economic recovery in a context of price stability. It will continue to assess the economic outlook in light of incoming information and is prepared to employ its tools as appropriate.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Charles L. Evans; Sarah Bloom Raskin; Daniel K. Tarullo; and

Janet L. Yellen. Voting against the action were Richard W. Fisher, Narayana Kocherlakota, and Charles I. Plosser, who did not support additional policy accommodation at this time.

Related Information from the Fed Website today

Maturity Extension Program and Reinvestment Policy

Frequently Asked Questions: Maturity Extension Program and Reinvestment Policy

Current FAQs

September 21, 2011

What is the Federal Reserve's maturity extension program (referred to by some as "operation twist") and what is its purpose?