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The First Step on a Long Path Toward Normalization

Over the past five years, the US Federal Reserve has been engaged in an aggressive campaign to provide support to a US economy that was badly damaged by the financial crisis and the accompanying Great Recession. The Fed's efforts have included the massive provision of liquidity to impaired financial markets, the purchase of more than US$3 trillion of long-term securities to ease overall financial conditions, and the issuance of forward guidance about the path of future short-term interest rates in order to lower borrowing costs across the yield curve. Although precise estimates of the effectiveness of these measures remain the subject of ongoing research, there can be little doubt that these policies have contributed to the process of repair and recovery of the US economy. Balance sheet deleveraging by businesses and households and an unwise shift of fiscal policy to a stance of appreciable restraint have weighed heavily on the economy, and the Federal Reserve's policies have provided a meaningful counterweight against those forces. Accommodative monetary policy has boosted interest-sensitive spending, especially for houses and motor vehicles, and it has lifted household wealth and consumer spending by raising prices for equities and houses. More recently, as the fiscal drag imposed by last year's cuts in federal spending and increases in taxes has begun to wane, there have been increasing signs that the pace of the economic expansion in the United States is picking up.

Against this backdrop, the Federal Open Market Committee (FOMC) – the Fed's policymaking group – announced at the conclusion of its policy meeting in December that it would taper back on the pace of its most recent program of asset purchases. Those purchases were scaled back further at the FOMC's January meeting. Moreover, Chairman Bernanke indicated at his press conference following the December meeting that if economic developments proceeded as currently forecasted, these asset purchases would be steadily tapered back and would likely be completed by late 2014. In contrast to the turmoil witnessed in financial markets after the Fed began talking about the prospect of tapering in the spring of 2013, the financial markets took the Fed's December policy decision largely in stride. The improving tenor of the recent economic data led a growing sense of comfort that the US economy and US policy are now firmly on a steady path toward normalization.

But this comfort is not warranted by current circumstances. The condition of the US economy, and most especially that of our labor markets, is far from normal. Moreover, inflation is running well below the Federal Reserve's established target of two percent. As a consequence, continued extraordinary monetary accommodation will be necessary for a very considerable period of time, and the process of policy normalization is likely to be a slow and uneven one. The recent turmoil in a number of emerging market economies may also be giving Fed policymakers some pause, though Fed decisions are heavily focused on domestic considerations. The policy statement issued after the January meeting certainly provided no indication that emerging market troubles were yet influencing their actions.

For now, the strategy for tapering appears reasonably clear. The FOMC will, in all likelihood, cut back on its purchases by about US$10 billion at each of its meetings, with this third round of quantitative easing concluding in the late fall of 2014. While the Fed has stressed that its decisions will be data dependent, the Chairman's ex-

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plicit description of the likely path of tapering suggests that the hurdle for deviating from this plan is reasonably high; the Fed may not be on autopilot, but they are not far from it. As tapering proceeds, we can expect long-term interest rates in the United States to continue to trend higher, and we can expect risk-taking by many investors to be gradually scaled back. If events unfold as currently expected, that tightening of financial conditions will be occurring in the environment of a steadily strengthening economy and thus will merely cushion the acceleration of activity, not derail it – that, at least, is the plan.

But events rarely unfold as planned, and the real work ahead for the Fed will be to remain responsive to the inevitable deviations from the current projections. Economic forecasters, including those at the Fed, have been serially over-optimistic about the country's economic prospects. We have experienced several bursts of favorable economic readings that did not ultimately lead to the above-trend growth that has so regularly been expected. The exceptional degree of enthusiasm expressed by many analysts immediately following the Fed's first tapering announcement was soon tempered when weak employment figures were reported for December. Conditions in the US labor market remain dismal. Growth in payroll employment in 2013 was no better than in 2012. And while the unemployment rate has been declining, most of that drop reflects people leaving the labor force rather than people finding jobs. The fraction of the US population that is currently employed has not improved since the recession ended and is more than four percentage points below its pre-crisis peak. For these reasons, the Fed needs to be prepared to stop tapering or even reverse course should there be any meaningful signs that the forecasted acceleration in real activity is faltering.

Recent inflation developments in the United States should reinforce a bias toward maintaining monetary accommodation. Consumer prices, as measured by the PCE price index monitored by the Federal Reserve, have risen just a bit above one percent over the past 12 months, well below the Fed's announced two percent inflation objective. Upstream inflation pressures are similarly subdued. Wage inflation has shown no signs of increasing, even as the unemployment rate has fallen, and commodity price concerns have abated considerably over the past year or so. In setting its path for policy, the Federal Reserve should not acquiesce to rates of inflation persistently below target. While deflation does not appear to be an immediate threat, any unforeseen shock that seriously weakened the global economy could bring that risk into play quickly and forcefully. The fact that the euro area finds itself in a similar situation on the price front only reinforces the deflation risks faced by both major economic areas.

As is always the case, there are risks on both sides of the policy ledger for the Federal Reserve. If the Fed removes its monetary accommodation too slowly, an extended period of extremely low interest rates raises the risk that asset prices and lending behavior will at some point come unhinged from fundamentals. The evidence does not suggest that this has come to pass in the United States just yet, but the risk must be taken seriously. For now, the risks associated with tightening too much too soon seem the decidedly greater ones. Very high levels of long-term unemployment are leading to diminished attachment of these workers to the labor force, and consequently their job skills deteriorating. The longer these conditions persist, the greater will be the damage to the productive potential of the US economy. With the economic recovery incomplete and with inflation falling well short of target, the Fed should be biased toward maintaining its support of the economy. The United States has been well served by the Federal Reserve's aggressive actions. The Fed should not back down now.