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WILL U.S. MONETARY POLICY NORMALIZATION OCCUR ANYTIME SOON?

by Vivekanand Jayakumar, Ph.D.

Since 2008, the Federal Reserve (Fed) has undertaken numerous policy actions, some of the conventional variety and others of the unconventional type. Through much of 2008 and early 2009, the Fed focused its efforts on staunching the fallout from a full-blown liquidity and credit crisis and on stabilizing the housing market. Later, the Fed's attention shifted to alleviating the macroeconomic problems afflicting the U.S. economy: an underwhelming economic recovery and a subpar labor market.

With U.S. fiscal policy increasingly being constrained by political discord, Fed actions have acquired greater significance. Monetary policy has now become the principal source of expansionary support for the U.S. economy as fiscal policy shifts towards tightening. The most prominent examples of recent fiscal policy tightening are sequestration and an increase in some taxes. Consequently, potential changes in the Fed's level of support and the resultant impact on the financial and the real sector has become one of the most widely discussed and debated issues.

Unconventional policies pursued by Fed over the past few years are presumed to be temporary actions and, at some stage, it is assumed that the Fed would desire a return to normalcy. However, given the unprecedented nature of recent interventionist measures, there is considerable uncertainty regarding the timing and the form of exit strategies. Pre-emptive withdrawal of support may hurt the pace of economic recovery and adversely impact jobs growth. However, persisting with the extraordinary measures currently in place may potentially create financial distortions and inflate new asset bubbles. As such, Fed policymakers need to get the unwinding process right or else they may face serious new threats down the road.

Prior to a discussion of likely future developments associated with U.S. monetary policy, a quick recap of the key developments since the start of the global financial crisis is relevant. U.S. economic and financial conditions deteriorated rapidly following the collapse of Lehman Brothers in September 2008. Financial risk rose sharply as concerns regarding the quality of assets on the balance sheet of financial institutions became widespread. Credit crunch became a reality as frightened institutions disengaged from normal short-term lending activities and became primarily concerned with solidifying their own capital base. Financial shocks spread to the real economy, hurting the labor market and the levels of consumption, investment and production.

The Fed actively played the role of lender of last resort during this turbulent period. Besides rapidly lowering short-term rates, the central bank undertook steps to unclog the U.S. financial system and ease credit and liquidity constraints. As financial institutions became fearful of dealing with each other as well as with their commercial clients, the Fed created a variety of programs (see Figure 1.1) to reestablish short-term credit flow and enhance liquidity so as to restore the normal functioning of both the financial system and the real economy. The Fed, for instance, provided support for participants in the money market and the commercial paper market, and established new lending facilities that allowed financial institutions to utilize relatively illiquid assets as collateral to obtain loans from the central bank. These actions were temporary by nature and most of them were quickly wound down as the financial system rebounded.

After successfully preventing a financial sector collapse, Fed's attention turned towards reinvigorating the moribund U.S. economy. The labor market (see Figure 1.2) was severely impacted by the Great Recession and the adverse effects persisted long after the end of the recession. Strikingly, the level of long-term unemployment rate reached 45.3 percent in March 2011 and the broad based unemployment rate—which takes into

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Figure 1.1: Assets on the Fed Balance Sheet ($ millions)
Source: Federal Reserve Bank of Cleveland

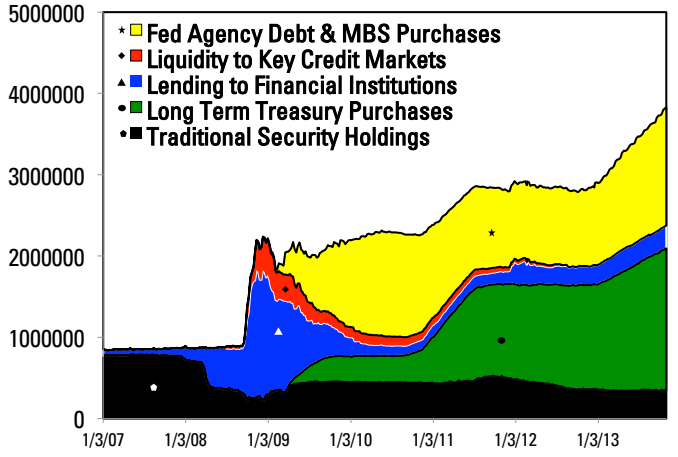
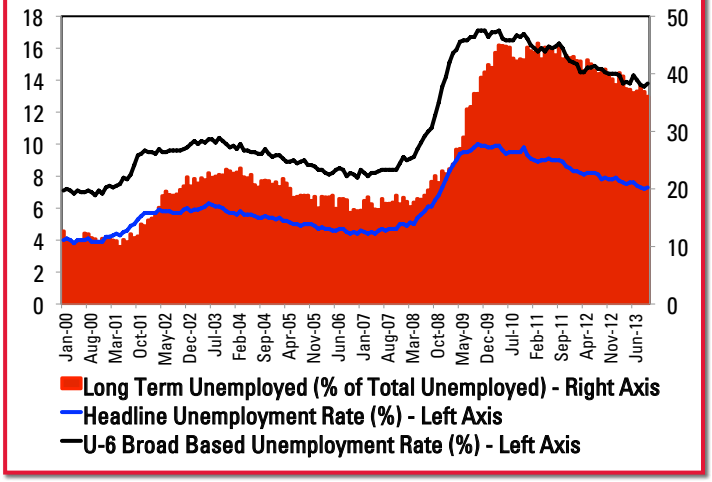


Figure 1.2: U.S. Labor Market Conditions 1
Source: Bureau of Labor Statistics



Will U.S. Monetary Policy Normalization Occur Anytime Soon?

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account discouraged and underemployed workers—briefly exceeded 17 percent in late 2009 and early 2010 and remained above 15 percent until February 2012. Concerned that European-style hysteresis—a phenomenon where harsh recessions leave lasting scars on the economy by raising the long-term natural rate of unemployment—may afflict the U.S. labor market, and fearful that the slow moving economy may tip back into a recession, the Fed undertook several rounds of unprecedented intervention to improve the U.S. macroeconomic climate.

The conventional approach to monetary policymaking typically involves the adjustment of short-term interest rates by central banks to influence aggregate demand and inflation expectations. However, as short-term nominal interest rates were driven down to near zero levels by December 2008 (see Figure 1.3), the Fed faced a dilemma posed by the presence of a zero interest rate floor for nominal interest rates. Essentially, nominal interest rates cannot be persistently kept below zero as households would then switch to just holding cash. Thus, unconventional measures were necessary to overcome the constraints on traditional policy tools. Two unconventional policy measures were adopted by the Fed: 1) large scale asset purchase programs—known as quantitative easing or QE—and 2) forward guidance.

The first round of quantitative easing—QE 1—began with the Fed's November 23, 2008 announcement to purchase $100 billion of Government Sponsored Enterprises (GSE) debt and $500 billion of Mortgage Backed Securities (MBS). In its March 18, 2009 statement, the Fed announced the expansion of QE 1, involving the purchase of $300 billion in long-term securities along with a further acquisition of $100 billion of GSE debt and $750 billion of MBS. QE 1 was largely oriented towards stabilizing and reviving the U.S. housing market. QE 1 related purchases were essentially over by the end of March 2010. By the end of QE 1, GSE debt purchases totaled $175 billion (lower than originally proposed total of $200 billion), and the Fed decided to reinvest principal receipts from QE 1 into U.S. Treasuries.

Continuing real economic weakness and fears that the U.S. may fall into a deflationary cycle, however, necessitated another round of QE. The Fed introduced QE 2 on November 3, 2010. With QE 2, the Fed engaged in the purchase of $600 billion worth of U.S. Treasuries through June 2011. In September 2011, the Fed formally announced that it would pursue "operation twist," which involved the conversion of short-term Treasury securities into long-dated Treasury securities. The goal of operation twist was to flatten the yield curve.

On the interest rate front, the Fed provided qualitative forward guidance between 2009 and mid 2011 by noting in its statements that it intended to keep the Federal Funds Rate target near zero for an "extended period." Later, the interest rate guidance became more calendar-specific. For example, in August 2011, the Fed noted that low rates may be needed at least through mid-2013; and, in January 2012, the Fed announced that the low rate environment would last at least until late 2014.

The more experimental phase of unconventional monetary policymaking began to take shape in late 2012. In its September 13, 2012 statement, the Fed announced two key measures. First, a new open-ended QE 3 with monthly purchases of $40 billion worth of MBS for as long as labor market conditions do not show substantial improvement. And second, an extension of its forward guidance commitment on short-term rates, whereby the Federal Funds Rate target will remain at near zero levels at least until the middle of 2015. QE 3 was further expanded in December 2012, with the announcement that the Fed would undertake open-ended monthly purchases of $45 billion worth of long dated Treasury securities, which would not be sterilized by sales of short-term government securities. Furthermore, in its December 12, 2012 statement, the Fed indicates a shift from calendar time specific guidance to economic thresholds based guidance regarding the

short-term interest rate target. The Fed now stated that near zero rates will be maintained as long as "unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."

Several critical objectives underlie Fed's unconventional policy approach. By buying long-dated bonds and by promising to hold down short-term rates for an extended period, the Fed is affecting rates across all maturities and reducing real returns on key government securities—such as the benchmark 10-year Treasury-note—and other safe haven assets. The assumption is that reduced returns on safe assets will encourage investors to acquire riskier assets such as equities and corporate securities. Resultant asset reflation is expected to create a positive wealth effect, as it emboldens consumers to increase their spending. Fed MBS purchases and yield curve flattening is also targeted at lowering mortgage rates to augment housing market activity. Other interest rate sensitive sectors, such as the auto market, are also expected to benefit from the decline in long-term borrowing costs. The Fed is also hoping that sustained low borrowing costs will encourage businesses to undertake fresh investments and thus positively contribute to both aggregate demand and jobs growth.

To a considerable extent, the Fed has been successful. U.S. equity indices have attained multiple record closings in 2012 and 2013. Meanwhile, interest rate sensitive areas, such as the housing market and the auto sector, have markedly improved over the past 15 months. Even the unemployment rate has declined to under 7.5 percent and real GDP growth rate appears to be stabilizing around the 2 to 3 percent range. Despite these generally positive developments, open debate exists regarding Fed's monthly purchases of $85 billion worth of securities as well as its explicit guidance regarding short-term interest rate levels.

As evinced by recent domestic and international financial market volatility associated with the timing of the Fed's bond purchase tapering, there is substantial uncertainty regarding the consequences of even a pullback of unconventional policy measures. Indeed, as speculation rose between May and September of 2013 that the Fed may be considering tapering of its bond purchases, yield on the 10-year Treasury-note rose by around 100 basis points, as shown in Figure 1.3.

Some economists, such as the Nobel Laureate Paul Krugman, are still unconvinced that the economy is strong enough for the Fed to be considering a pullback from its current QE 3 program. They argue that the major contributor to the decline in the unemployment rate has been the sharp drop in labor force participation rate. Improvements in non-farm payroll jobs numbers have been modest at best. The employment-population ratio declined rapidly during the crisis and has yet to bounce back up (see Figure 1.4). Critics of early withdrawal of monetary stimulus also observe that actual and expected inflation rates are quite low (see Figure 1.5) and there is no evident risk of an inflation surge on the horizon as inflation expectations appear to be well anchored.

Importantly, a surge in Fed's liabilities—essentially, the monetary base or currency in circulation plus reserves held at the Fed by banks—has not led to a rapid growth of money supply in the U.S. Indeed, the M1 money multiplier—the ratio of M1 money supply to the monetary base—has been below 1 for much of the past five years. This is largely a result of the surge in excess reserve holdings by U.S. financial institutions (see Figure 1.5). Though the Fed has created several trillion dollars of reserves to acquire MBS and Treasuries, most of it has ended up back at the Fed as bank reserve deposits.

Other economists, such as Ronald McKinnon and John Taylor of Stanford University, are, however, critical of Fed's unconventional policy measures and argue that a quick return to monetary policy normalization is essential for putting the U.S. economy on a more solid footing. They fear that artificially limiting long-term rates is creating financial distortions and

Figure 1.3: U.S. Interest Rates (percent)
Source: Federal Reserve Bank of St. Louis

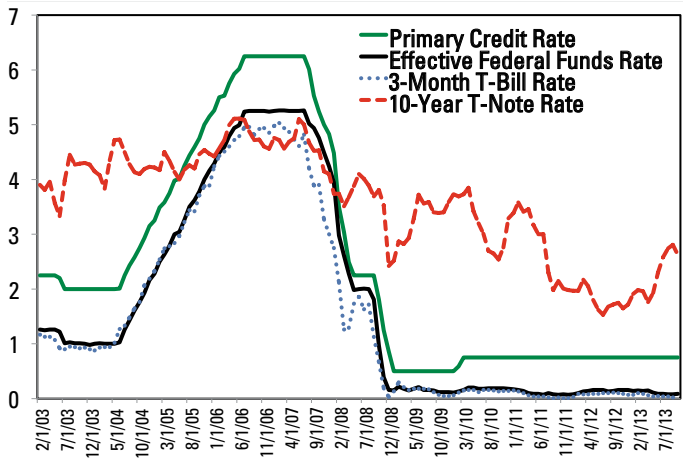
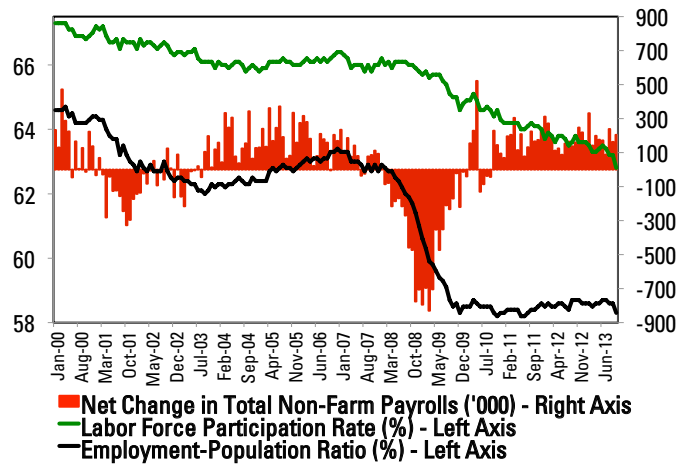


Figure 1.4: U.S. Labor Market Conditions 2
Source: Bureau of Labor Statistics

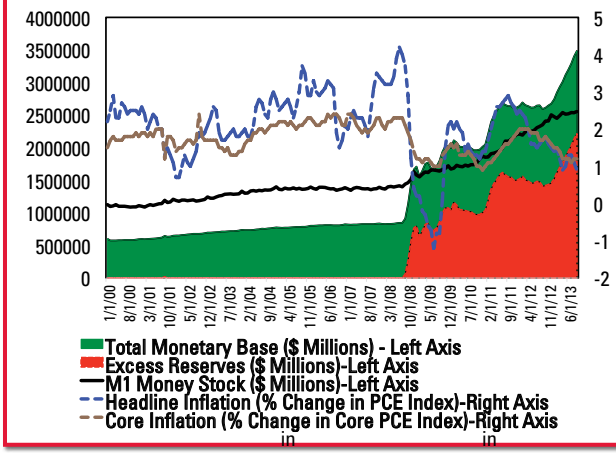


leading to uncertainty regarding the genuine fundamental value of equilibrium interest rates. They also argue that after multiple rounds of QE, real GDP growth and job creation remain disappointing, suggesting that the net benefit may be less than the potential long-term cost.

Many non-U.S. economists have expressed concern that Fed's policies have generated tremendous volatility in global capital flows. Market expectation of a continuation of the Fed's easy stance often drives capital abroad in search of higher yields. However, a switch in expectation towards potential Fed tightening leads to a return of capital back into the U.S. Fed actions have also affected global currency and commodity markets.

There is thus obvious disagreement regarding the need for continuation of unconventional monetary policy actions. Recent comments from various Fed officials suggest that tapering of bond purchases is likely to be implemented gradually and driven to a large extent by data—particularly, labor market figures. There is, however, widespread belief that short-term interest rates in the U.S. are likely to remain at near zero levels for at least two more years. In fact, some—such as the President of the Federal Reserve Bank of Minneapolis—are recommending that the Fed lower its action target for unemployment rate to 5.5 percent from 6.5 percent in order to convince market participants that, while bond tapering may occur in the near term, rate increase expectations should be postponed for several more years. Clearly, we are quite far from a full return to monetary policy normalization in the U.S.

Figure 1.5: U.S. Monetary Conditions
Source: Federal Reserve Bank of St. Louis



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THE TAMPA BAY ECONOMY: NOVEMBER UPDATE

by Brian T. Kench, Ph.D.

The Tampa Bay metropolitan statistical area's (Hernando, Hillsborough, Pasco and Pinellas counties) recovery from the Great Recession moves forward. Gross sales continue to grow, albeit at a slower pace; employment in Tampa Bay is expanding faster than most other Florida metro areas and unemployment is declining. Although existing home price appreciation continues, the pace of new home permits has declined over recent months.

Gross sales in Tampa Bay totaled $8.9 billion in August 2013, a 1.4 percent increase from August 2012 (see Figure 2.1). The year-on-year change in gross sales averaged 5.8 percent per month for 2013, which is faster than the 2012 average by 0.7 percentage point. Since March 2010, the year-on-year change in gross sales has averaged 6.3 percent per month.

Figure 2.2 illustrates Tampa Bay's job loss duration because of the Great Recession and the last two U.S. recessions. As of August 2013, 5 years and 7 months have passed since the recession began in December 2007 and the area remains net negative 51,500 jobs, which is 4.1 percent of December 2007 employment level.

The year-on-year percent change in nonfarm payroll jobs for Tampa, Florida and the U.S. are shown in Figure 2.3. As of August 2010, Tampa's year-on-year job growth turned positive. By October 2012, Tampa's job growth began to accelerate

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Figure 2.1: Gross Sales in Tampa Bay: January 2007 – August 2013
Source: Florida Department of Revenue

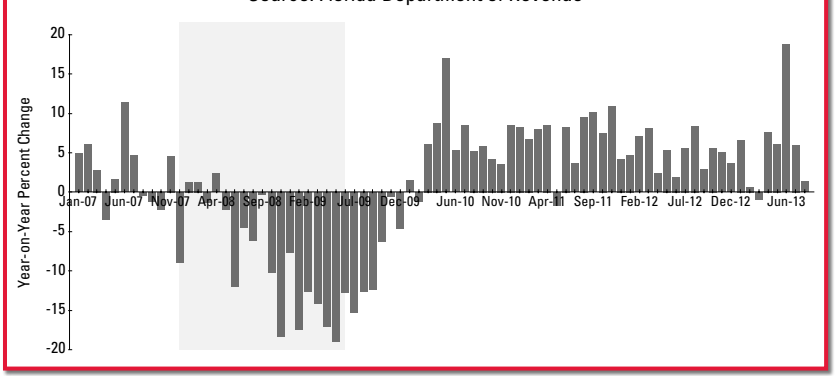
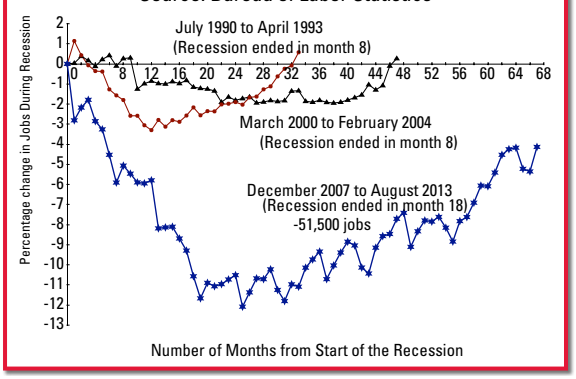


Figure 2.2: Duration of Job Loss in Tampa Bay
Source: Bureau of Labor Statistics



The Tampa Bay Economy: November Update

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faster than the job growth in Florida and the U.S. Nonfarm payroll jobs in Tampa Bay increased 3.6 percent in August 2013, relative to a year earlier.

Figure 2.4 reveals that Tampa Bay has been adding nonfarm payroll jobs year-on-year at an accelerated pace over the last few months when compared to other Florida metro areas. Only the Naples metro area has expanded at a faster clip over the June to August time frame.

The unemployment rate measures the ratio of those unemployed and looking for work divided to the labor force. In Tampa Bay, the unemployment rate (NSA) was 6.8 percent in August 2013, which is lower than the national unemployment rate (SA) by 0.4 percent and the unemployment rate (NSA) for the state of Florida by 0.2 percent. Despite its elevated level, the Tampa Bay unemployment rate fell in August 2013 relative to August 2012 by 1.8 percent. Lastly, in August 2013, the unemployment rate (NSA) was 8.5 percent in Hernando County, 6.7 percent in Hillsborough County, 7.8 percent in Pasco County and 6.7 percent in Pinellas County.

The S&P's Case-Shiller housing price index (HPI) for Tampa Bay is based on observed changes in home prices in the area. Figure 2.5 shows the high, middle and low tier HPI segments of the Tampa Bay housing market. The top third of Tampa Bay's housing market—the high tier segment—reached a maximum value of 225.96 in May 2006. The high tier declined 43.1 percent over more than five years to reach a low HPI value of 128.73 in September 2011. As of August 2013, this segment of the Tampa Bay housing market has increased nearly 18.7 percent. The middle third of Tampa Bay's housing market—the middle tier segment—reached a maximum value of 244.56 in June 2006. The middle tier declined 52.3 percent over more than five years to reach a low HPI value of 116.7 in November 2011. As of August 2013, this segment of the Tampa Bay housing market has increased 24.2 percent. The bottom third of Tampa Bay's housing market—the low tier segment—reached a maximum value of 279.07 in July 2006. The low tier declined 63.2 percent to reach a low HPI value of 102.93 in December 2011. As of August 2013, this segment of the Tampa Bay housing market has increased over 30 percent.

Figure 2.6 shows the absolute number of privately owned one-unit residential permits for new homes in the Tampa Bay area. New permits for August 2013 totaled 595. The average number of new permits for July and August is 18.2 percent lower than the average number of new permits for January through June of this year.

In summary, recent data continue to point in a very positive direction. Gross sales in Tampa Bay continue to grow on a year-on-year basis. The area is adding nonfarm payroll jobs—the year-on-year change in nonfarm payroll jobs has been positive for 39 months and Tampa Bay's employment momentum is impressive. Unemployment rates are falling. And the housing market remains strong.

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Figure 2.3: Nonfarm Payroll Jobs: January 2000 – August 2013
Source: Bureau of Labor Statistics

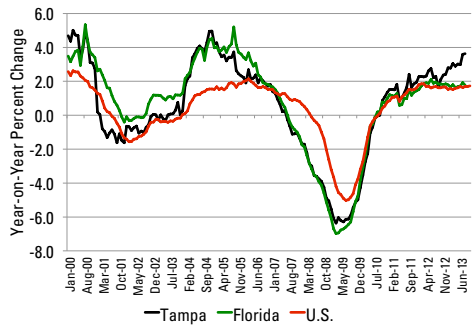

Figure 2.4: Florida Employment Momentum by Metro Area: August 2013
Source: Bureau of Labor Statistics

Note: The size of the bubbles reflects the relative employment size of each metro area.

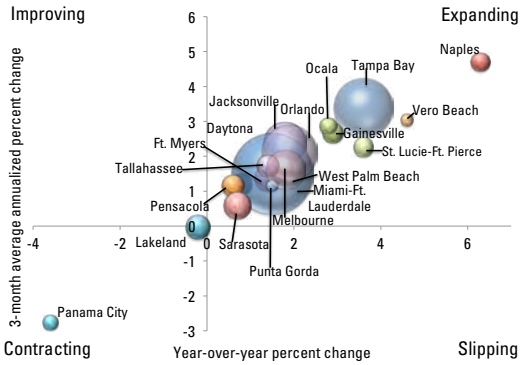

Figure 2.5: Case-Shiller HPI: 1987 – 2013
Source: St. Louis Federal Reserve

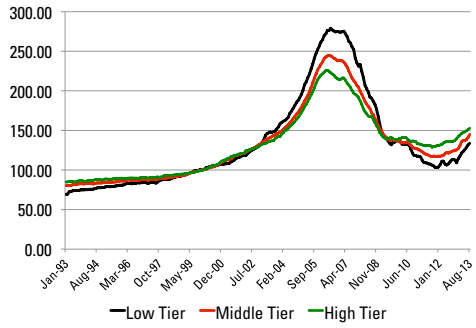

Figure 2.6: Number Residential Building Permits: January 1990 – August 2013
Source: U.S. Department of Housing and Urban Development

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