

Viewpoints

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Fed's Exit Best as Process, Not Event



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A rebound in the global economy appears to be taking hold, reducing pressure on the world's central banks to provide additional monetary stimulus. Attention is turning instead toward how and when central bankers will begin to reverse their policies and remove the massive amount of financial liquidity they have injected into the world's financial system since the onset of the financial crisis. Few believe, however, that there is any urgency to removing the stimulus, because the recovery is still fragile and not yet at the point where it can be characterised as self-sustaining.

The fragile state of the world's economic and financial situation makes it imperative that central bankers exit their current stances on monetary policy in a way that is more of a process than an event. Done this way, financial markets will likely adjust smoothly to a reversal in policy, limiting any potential damage to the world's economy that could result from setbacks in the markets.

Attention tends to be most squarely on the United States, which has been at the centre of the economic and financial crisis. Substantial progress has been made there, with financial markets having rebounded sharply and economic growth returning. The rebound is directing attention toward the Federal Reserve and its very accommodative policy stance.

The Federal Reserve's Exit

For the Federal Reserve, the best approach to exiting its current stance may be to condition any change in its commitment to low policy rates to economic and financial conditions. Done this way, market participants may more readily decipher whether a policy change might be in the offing. This is an approach the Federal Reserve apparently has decided upon, having conditioned its commitment on rates in its 4 November policy statement. The Fed did this by adding in three conditions that will likely determine the future course of monetary policy:

"The Committee will maintain the target range for the federal funds rate at 0% to 0.25% and continues to anticipate that economic conditions, including low rates of resource utilisation, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

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In citing these three conditions, the Federal Reserve has provided a roadmap by which market participants may gauge with greater precision the evolution of monetary policy, in particular the exit strategy for its current stance.

The roadmap will help guide market participants to react incrementally and in process-like fashion to incoming data rather than react suddenly to either the Fed's policy statements or speeches by Federal Reserve officials. This will help make the implementation of its exit strategy more a process than an event. It may also give the Fed an "out" because incoming data related to the three conditions mentioned will likely take on greater weight than the Fed's own words, allowing the Fed to simply rubber-stamp the conclusions drawn by market participants regarding the incoming data.

By making conditional any changes to its policy commitment, the timeline for future Fed policy changes may be left unchanged, which should also smooth the market response.

Inflation Expectations Challenge the Fed

The Fed appears to be quite confident about the inflation outlook, despite indications of concern by financial market participants. This is evident in the fact that the Fed kept its inflation comment intact:

"With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain subdued for some time."

It is intriguing that the Fed would label inflation expectations "stable" when the amount of inflation expectations embedded in 10-year inflation-protected Treasuries was at its high for the year on the day the Fed last met. Ever since then, inflation-protected securities have priced in even more inflation, suggesting the financial markets felt the Fed wasn't worried enough about inflation prospects. Moreover, other barometers widely used by market participants to gauge inflation expectations have been signalling increases in inflation expectations, including gold and the value of the US dollar.

The question of the day is whether rising inflation expectations are enough to overwhelm the other two conditions the Fed set forth. In other words, will the Fed focus solely on unemployment and sit idly by if inflation expectations continue to rise? With unemployment likely to persist, this creates a challenging situation for the Fed and will likely intensify the response in financial markets to incoming data. It could also increase market volatility if investors are unsure which of the three conditions the Fed set forth is carrying the most weight.

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