Northern Trust

ECONOMIC UPDATE

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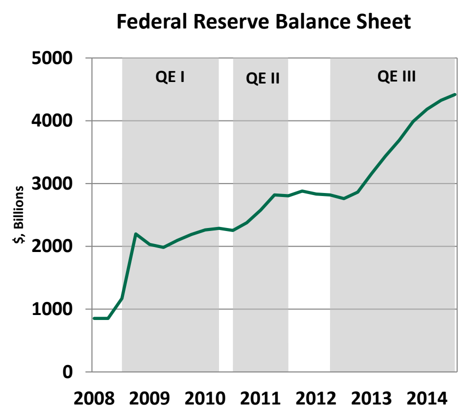
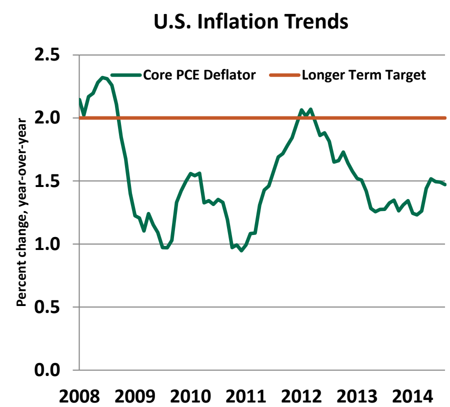
• October FOMC Meeting: The End of Asset Purchases

The Federal Reserve began its program of quantitative easing (QE) in 2008. The Federal Open Market Committee (FOMC), after adding more than $1.5 trillion of securities to the Fed' s balance sheet, confirmed today that the third leg of that effort will officially end next month.. The sunset is reflective of improving economic performance and a broadening sense that the program's effectiveness has diminished.

We won't be able to fully assess the ramifications of QE for some time. It's clear that the effort has lowered long-term interest rates in the United States, and it has likely aided asset valuations. Both are helpful to economic activity. Potentially unpleasant side effects, such as hyperinflation, a very weak currency, or market bubbles, have yet to appear. But building the Fed's portfolio may turn out to be the easy part; the exit strategy, when it begins, will be a tricky endeavor.





Source: Bureau of Economic Analysis, FRB, Haver Analytics

Minneapolis Fed President Narayana Kocherlakota dissented from today's decision, expressing a preference for keeping QE going until the inflation picture centers more closely around the Fed's 2% target. Declining commodities prices and a falling dollar are creating a situation in which the United States is functionally importing disinflation from other parts of the world. In light of all this, market-based expectations of inflation have fallen quite a bit in the last two months.

But the Fed statement seemed to downplay this development, contrasting market indicators with forecast surveys showing inflation expectations that are little-changed. As we discussed in last Friday's weekly, we do not expect disinflation to go too much further. Today's post-meeting statement retained the phrase, "…the likelihood of inflation running persistently below 2 percent has diminished somewhat since early this year." The distance between current inflation and the Fed's 2% target is large enough to keep the FOMC from raising rates for a while but not enough to justify extending the asset purchase program.

The Fed's communication around the tapering of asset purchases has been very effective, so there was little market reaction to their suspension. There is broader understanding than there used to be that tapering is not tightening; current monetary policy, across the developed world, remains extraordinarily accommodative.

One hopes that messaging around interest-rate increases will be similarly well-handled when the time comes. It appears that the FOMC will have a "considerable period" to contemplate appropriate language, as the statement following today's meeting does not suggest urgency around normalizing monetary policy.

Asset purchases have served their purpose, but the time has come to stop them.

The depiction of labor market conditions in today's statement was something of an upgrade from prior communication. Last month, the committee cited "significant underutilization of labor resources." Today, it noted that the "underutilization of labor resources is gradually diminishing." Risks to the outlook were again characterized as "balanced."

The absence of dissent from the more-hawkish members of the FOMC led some to suggest that the group had become less dovish. That might be a bit of an exaggeration; the statement provided an objective accounting of available information and did not take a strong step toward tightening credit.

Upon further reflection, it might be unfair to judge quantitative easing in retrospect. The program was initiated during a time of incredible uncertainty, when information was far more limited than it is today. Having learned from past experience in the United States and Japan, the Fed chose to go quickly, go big and stick with it for a long time.

The alternative – doing nothing – would certainly have deepened the 2008 recession and made recovery much more difficult. That is the painful lesson that the European Central Bank may now be learning. And that is the benchmark against which the Fed's QE program might most fairly be judged.

The Fed was certainly aware then, and is now, that unwinding the program would be difficult. But it contemplates the next phase from a position of much greater economic and market strength. Monetary policy continues to face challenging problems, but the problems are much less serious than the ones we faced six years ago.