Blast Email on Monetary Policy: Meandering Bazooka Addition

Bill Nelson | October 08, 2020

On July 17, I distributed the note below to those who have signed up for my free occasional emails on monetary policy. We decided it was worth redistributing as a blog because it contains some thoughts about possible policy actions over the medium term—and conditions under which the FOMC would take them—that remain relevant.

To: Monetary Policy Analysis Distribution List
Date: July 17, 2020
From: Bill Nelson
Subject: Blast Email on Monetary Policy: Meandering Bazooka Addition

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Comrades,

Is it just me, or is monetary policy sort of boring lately? Short-rates are at zero and not going negative. Forward rates are at zero for essentially forever, so there isn't much to be done with forward guidance. And term-premiums on longer-term securities are at record lows, so there doesn't seem to be much for a Large Scale Asset Purchase (LSAP) program to do either. Plus, the Fed is already buying Treasury and Agency securities much faster than it did under QE3, but for no particular reason, according to Chair Powell. Yield curve targeting fizzled as everyone knew it would. Even the radical purchases of corporate bonds seem dull. The Fed is just doing them because it said it would, not because there are any particular problems to fix in corporate bond markets. And honestly, if the FOMC is waiting to finish its highly academic discussion of its policy framework to take serious action, it must not feel a lot of urgency.

When, then, will we get the fireworks? When do the bazookas come out? And which bazookas, exactly?

Well first, the economic outlook has to clear up, and I don't mean in a good way. As the Committee keeps repeating, the outlook is bimodal. Either we get a solid recovery in the second half and nothing much more needs to be done, or we double dip and its soup-kitchen time. Polices that make sense along one path don't make sense along the other.

With one exception – conditional forward guidance: a promise to keep rates at zero at least until certain conditions are met. Date-based guidance doesn't work because the FOMC could end up seriously regretting a date that is far enough into the future to be helpful along the bad path, while announcing a date appropriate for the good path at this point could push rates up rather than down because investors could move forward their expected date of liftoff. Conditional guidance, especially guidance based exclusively on inflation rather than both inflation and unemployment, would work well. There is no particular reason to include the unemployment rate – the only reason the Committee wouldn't want the unemployment rate to be low would be if it caused inflation – and promising to keep rates at zero until inflation had persisted above the FOMC's target of 2 percent for some time could reduce the likelihood that people will start marking down their expectations for inflation. If inflation expectations start to move down, that's when the big guns come out.

Although it's the nominal (that is, the regular) interest rate that gets all the attention, it's the real interest rate – the nominal interest rate minus the expected rate of inflation – that determines whether monetary policy is slowing or stimulating the economy. If your investment is just providing you a return equal to the rate of inflation, then you are earning back dollars that can only buy the same amount of stuff as the dollars you invested; that is, you are earning a zero real rate of interest.

Currently, nominal interest rates are zero and expected inflation is probably about 1¾ percent, so the real interest rate is -1¾ percent. That's low enough to help stimulate the economy. But the unemployment rate is far, far above the level consistent with stable inflation (the "NAIRU" or "non-accelerating inflation rate of unemployment"), and that gap is going to push wages and general inflation down. As inflation falls, or is expected to fall, inflation expectations will move down, and that will move *up* the real interest rate. Monetary policy will be tightening, stimulus will be declining, and that reduced stimulus could push the unemployment rate higher still. The higher unemployment rate would push down inflation, lowering inflation expectations further, and so on.

That's a deflationary spiral and that is what everyone is really afraid of. That's when the bazookas come out.

It is worth noting that while it was surprising that inflation didn't move up much at all when the unemployment rate had fallen below 4 percent pre-Covid, it was equally if not more surprising, and fantastically lucky, that inflation didn't move down much in 2008-09 when the unemployment rate rose to 10 percent. The standard explanation for that lack of movement is that inflation expectations are "well anchored." Because expected inflation doesn't move much, actual inflation doesn't move much. The Fed's ongoing discussion about its monetary policy framework is mostly really about how to keep inflation expectations well anchored. Actually, I'm not sure what's not to like about the experience over the past 18 years. I hope they don't switch to some difficult-to-communicate policy and mess things up. Anyway, if inflation expectations, or even inflation, start to move down, I expect the FOMC to quickly take additional forceful action.

Two things make for a good bazooka. First, it has to be scalable. If you do it and things don't get better, you have to be able to do it again, even more so. You have to be able to "do whatever it takes." Second, it has to be unfalsifiable. No matter what happens, you must be able to credibly claim that it is working. Luckily, you can almost always say "well, things might be bad, but they would have been even worse without the bazooka." As discussed in this FT article, while FOMC leadership insisted that they would stop QE3 if it didn't work in order to get Committee consensus at the start, there was no way that was ever actually going to happen, which is partly why the FOMC ended up buying more than twice the amount of securities than originally projected under QE3. Seriously, with the economy in dire straits, would the FOMC ever announce that it was going to stop doing something because it wasn't working?

The go-to bazooka is going to be long-term asset purchases, "LSAPS" or "QE" of long-term Treasury securities or Agency MBS. Even though long-term rates are incredibly low, they can always get lower. Also, in a world where an LSAP is needed, the Federal deficit will be even higher, and the purchases would help ease the burden of all that debt issuance. I expect the LSAP would be structured as a flow-based program like QE3 where the Committee promises to keep buying until certain economic conditions are met.

Bazooka #2 will be ramping up the purchases of corporate bonds. The Fed and Treasury are together currently purchasing investment-grade corporate bonds through their Secondary Market Corporate Credit Facility (SMCCF). The Treasury has allocated $25 billion in equity to a special purpose vehicle (SPV) on the books of the Fed to purchase the bonds, and the Fed is willing to lend up to

$225 billion to the SPV to finance the purchases. The SPV has also purchased exchange-traded-funds (ETFs) that invest in corporate bonds. As of July 15, the facility had only purchased $15 billion in ETFs and Bonds.

The corporate bond purchases make a good bazooka because they can be scaled up almost indefinitely (the Treasury still has, I believe, $260 billion in CARES Act funding to invest if it chooses to) and the bond purchases cannot be shown to have been unsuccessful. Whatever corporate bond rates actually do, they will always be lower than they would have been without the purchases. When the Fed decides to go for shock and awe, it will increase the size of these purchases. It could also extend eligibility to slightly-below-investment grade bonds, as it has already done for its primary market purchases of corporate bonds.

The Fed will not, however, purchase, or create an SPV that will purchase, equities, at least not without a change in the law. As discussed in the chapter "The Legal Authorities Framing the Government's Response," in Bernanke, Geithner, Paulson "First Responders," the Fed's emergency lending authority under Section 13(3) of the Federal Reserve Act allows it to "discount... notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the [lending] Reserve Bank...." Bonds are notes, equities are not notes. While it's true that the Fed is lending to the SPV and the SPV would be buying the equities, according to the BGP chapter, the Fed sees the SPV as simply a vehicle to manage collateral and provide transparency. Yes, the SMCCF purchases ETFs, and ETFs are not a note, draft, or bill of exchange; but the Fed may be thinking of the ETF as a pass-through vehicle so that the Fed sees itself as discounting the bonds owned by the ETF.

One tool that could be deployed is a funding-for-lending program (FFLP) along the lines of ones adopted by China, Brazil, Japan, Singapore, Sweden, Switzerland, Korea, the United Kingdom, and the ECB. As I wrote in May, the Fed could auction large amounts of discount window loans with a negative stop-out rate and a maximum bid amount equal to the bidding bank's recent increase in some targeted type of lending, such as SME lending. An FFLP is not, however, a perfect bazooka. While it is scalable – the auction amounts can always be increased, the stop-out rates reduced, or the covered type of bank lending used to determine maximum bid amounts expanded – it is falsifiable. In particular, the take up can be low, and the Fed can't claim the facility is encouraging more lending to the real economy than the FFLP lends to banks. Internationally, FFLPs have been seen as not very effective. Still, if the Fed becomes concerned about deflation, I'd expect it to open an FFLP.

Indeed, I wrote in April that I thought the Fed might open an FFLP relatively soon. At that time, the Fed had just announced (see press release here) an extraordinary change to its treatment of daytime overdrafts in banks' accounts at Federal Reserve Banks. In particular, the changes allow banks to incur unlimited, uncollateralized, and free daylight overdrafts. I had thought, perhaps, the Fed was seeking to free up the discount window collateral normally used to secure daylight overdrafts so the collateral would be available for an FFLP.

However, now I think something else is going on. Without announcement or explanation, the Fed has stopped publishing data on daylight overdrafts. Historically, and up until recently, once a quarter the Fed has published data on the peak and average daylight overdrafts experienced over each two-week period in the quarter. (The data are available here). The data were released about one month after the end of the quarter. But the Fed never published data on the first quarter of this year. It seems doubtful that the two mysteries are unrelated. Maybe something the Fed doesn't want to talk about happened in March that would be revealed by the data and that led to the daylight overdraft policy change.

Rather than taking the punch bowl away when the party gets started, if there is risk of a deflationary spiral the Fed will be the guy rummaging in the back of the liquor cabinet at the end of the night saying "Hey! Don't leave!" One two-thirds empty bottle of peach schnapps the Fed could pull out in such circumstances is negative interest rates. The Fed has said negative interest rates are off the table, and there is a consensus they can't go negative by much and don't provide much stimulus. But everything will be on the table if inflation expectations start moving down.

Please feel free to forward. Always happy to discuss. And let me know if you would like to stop receiving these emails. I promise not to be hurt.

— Bill

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