

## Questions Surrounding the Fed's 'Exit Strategy'

The U.S. economy, despite officially in recovery from the most severe recession since the end of the Great Depression, still shows signs of weakness in the labor market: Nearly 10 percent of Americans are out of work and face very real difficulties. As a result of the relatively sluggish pace of this recovery and because of the low rates of inflation we have been experiencing, the Federal Reserve has continued to pursue accommodative monetary policies. The target for the federal funds rate remains between 0 and 0.25 percent, and in November the Fed decided to expand its balance sheet (which was already more than \$2 trillion) by another \$600 billion by the end of the second quarter of 2011 through the purchase of long-term Treasury securities. These actions reflected the view that the risk of further economic weakening outweighed the risk of inflation.

Currently, the outlook for inflation remains good. Prices, measured broadly, rose only about 1 percent over the last year, less than half of the rate during the years preceding the recession. Moreover, it appears that market participants believe that inflation will remain relatively low — around 2 percent on an annual basis over the next five years. Nevertheless, the Fed remains steadfast in its commitment to maintaining price stability. Doing so requires varying the degree of monetary accommodation as overall economic conditions vary over the business cycle. As the economic recovery picks up, there will come a time when monetary policy will need to be less accommodative. In short, the Fed must consider an “exit strategy” and be prepared to implement it when growth has become strong and well established.

Decisionmaking regarding monetary policy is always an inexact process. The Fed — meaning both the Board of Governors and the 12 Reserve Banks — employs sophisticated models as well as more “on the ground” anecdotal information to assess the likely path of the economy and which policies to pursue as a result of that evaluation. But the task at hand is particularly tricky. The Fed must be careful not to tighten too quickly, a course that could potentially stifle the recovery. At the same time, it must not be too loose for too long and potentially stoke inflation. In other words, it's not a question of whether the Fed should change course — but of when and how.

I don't have a rigid timeline about the “when” part of that issue. That will depend upon how the economy behaves in coming months. Most private forecasters are predicting that growth will be roughly 4 percent in 2011. My own view is in line with that.

As for the “how,” the central question has to do with sequencing. The Fed has a few options for withdrawing

monetary accommodation. It could first raise the interest rate on reserves that commercial banks hold at the Reserve Banks, and then reduce the size of the balance sheet through asset sales. This would put upward pressure on other short-term interest rates since banks would not be willing to supply short-term funds to the money markets at rates significantly below what they can receive by holding reserves with the Fed. Commercial banks' reserve balances would remain elevated, however, due to the delay in asset sales, and this would put downward pressure on interest rates.

An alternative is to begin selling assets before raising short-term interest rates. This approach would eliminate more rapidly the distortions caused by the Fed's intervention in mortgage-backed security markets, and would have the advantage of providing more confidence to market participants in projecting the effects of raising the interest rate on reserves, when the time comes.

My colleagues on the Federal Open Market Committee have discussed the merits of these alternative approaches to withdrawing monetary accommodation, but no decisions have been made. There is a consensus, however, that keeping the federal funds rate near zero indefinitely is not tenable — it will have to rise over time.

Evidence that the economy appears to be picking up pace brings with it weighty questions about how the Fed should respond, just as the financial crisis did. Happily, the questions we now face involve analysis of the pace of recovery rather than the pace of decline. My colleagues and I will give these questions the same careful scrutiny that we did when the economy faced the shocks that led to the recession of 2007-09.



A handwritten signature in black ink, appearing to read 'Jeff M Lacker'.

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