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Dot Plots Are Not Enough In A QE World

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As argued in our recent global macroeconomic update (see "Global Economic Outlook Q3 2021: Picking Up Steam, Fueled By Vaccinations"), we are now in the vaccination-driven exit phase of the pandemic, led by the advanced economies. Demand and inflation have picked up--particularly in the U.S.--and in terms of monetary policy, this implies a shift to normalization from COVID-19 damage control. For central banks, this exit process is not a one-dimensional decision to "raise rates." Rather it will involve communication about and the adjustment of two variables: the policy rate and the amount of asset purchases or sales. Is the current apparatus up to the challenge?

In our view, while the Fed's dot plots were a sufficient input from policymakers to forecast financial conditions in the past (pre-global financial crisis), in a QE (quantitative easing) world, they are unlikely to be so.

Our base-case macro scenario includes an orderly reflation of key variables as we exit the COVID-19 crisis: inflation, wages, and earnings. An important component of this assumption is the withdrawal of monetary policy stimulus in a way that does not generate unnecessary market volatility. This, in turn, relies in part on the communication strategy, including central banks' forward guidance.

Staying with the U.S., the Fed's main signaling apparatus is the well-known dot plot, published as part of the Summary of Economic Projections (SEP). Released quarterly, the dot plots show the forecasts for key macro variables and the Fed funds rate of various FOMC participants over 2021-2023 and the longer run. The latest dot plot shows that inflation expectations have increased in 2021 and, to a lesser extent, in 2022 and that the expected timing of policy rates hikes has been brought forward[1]. Importantly, the Fed's enhanced forward guidance includes clarity on the Fed funds rate while it lacks the same level of transparency on asset purchases, which are not part of the SEP and limited to FOMC statements.

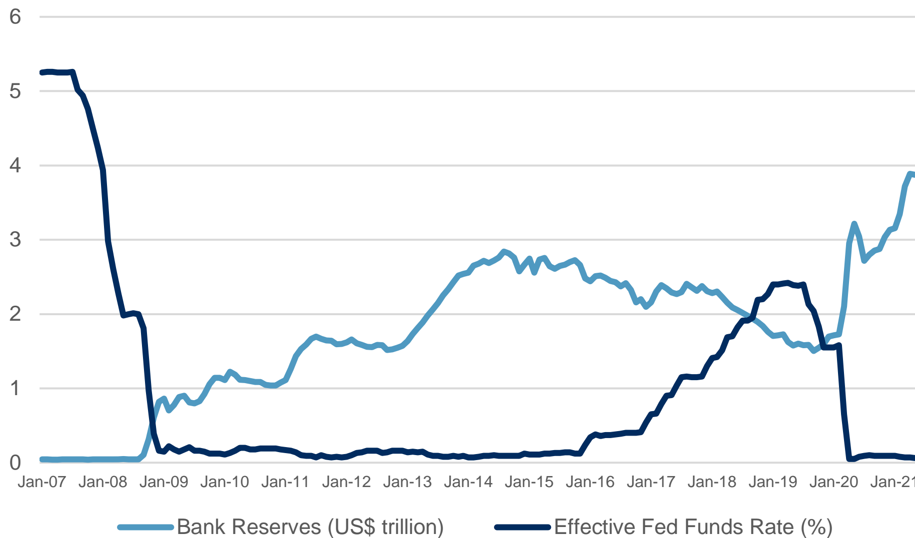
But there is now more than one policy variable at play. While the Fed funds rate was the only game in town until the global financial crisis, that is no longer true. After the policy rate hit the "effective lower bound" in late 2008, the Fed began to purchase assets (U.S. Treasury bonds and mortgage-backed securities) to continue to generate the required further easing of monetary conditions. These asset purchases had a counterpart in (excess) bank reserves (see chart 1). Excess reserves are proxied by bank reserves. In reality, banks held small amounts of reserves before QE.

[1] https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20210616.pdf

Chart 1

US Fed Funds Rate and Bank Reserves

(in percent, and US$ trillions)



Source: FRED

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Why is this relevant? As we have noted elsewhere (see "A Future For QE: Monetary Policy In Two Dimensions"), this "monetary policy in two dimensions" is not symmetrical with respect to time: there will be no retracing of steps. As monetary conditions need to be tightened, the Fed will not reverse course and run its QE balance down to zero and then start lifting the policy rates, undoing what was done in late 2008. Indeed, it has already demonstrated from December 2015 that it will lift the Fed funds rate off of zero while still leaving sizable excess reserves in the system (which need to earn interest in the policy rate target range). This will likely be the case going forward as the Fed has noted that QE will be part of the policy toolkit[2].

Returning to guidance, unlike for the Fed funds rate, there is no numerical projection from Fed governors about the future size of the balance sheet. This is a meaningful omission, especially since QE is likely to be around for some time. Even if asset purchases (the flow) are tapered down to zero, the Fed will still be a major holder of government paper (the stock). The arguments here carry over to other central banks undertaking QE as well.

Bottom line: While the Fed's dot plots were a sufficient input from policymakers to forecast financial conditions in the past (pre-global financial crisis), in a QE world, they are unlikely to be so. For example, financial (and credit) conditions are certainly different between, say, a policy rate of 2.5% and no QE (or excess reserves) and 2.5% and $4 trillion of excess reserves in the banking sector. Communicating both a projected Fed funds rate and a stock of assets or excess reserves on the balance sheet will better guide expectations around financial conditions and help to ensure the desired orderly reflation and recovery.

[2] In other words, "... the theory of monetary policy now needs to recognize the existence of two independent policy instruments – a short-term interest rate and the size of the central bank's asset portfolio – rather than just one as in traditional theory." See: https://www.nber.org/system/files/working_papers/w20128/w20128.pdf.

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