Beyond Monetary Policy

Throughout the economic recovery, Fed economists keep their eye on the bottom line: people.

By historic standards, 2011 was a chaotic year around the globe. Yet, despite the chaos, the Boston Fed never took its eye off the prize of doing its best to foster macroeconomic conditions that encourage job creation and price stability: the two elements of the Fed's "Dual Mandate" that form the backbone of the Fed's charge from Congress.

In a climate of fragile recovery in the wake of an enormous recession, 2011 began with optimism. In February, the expectation was 3.5% growth in an economy that had yet to fully find its feet. In reality, the year's growth reached just half of that prediction. Despite frustrations, Boston Fed Executive Vice President and Senior Policy Advisor Jeff Fuhrer still kept his focus on what matters most: people.

"In this Bank, we're actually pretty good about keeping our eye on the bottom line, and the bottom line is whether we're delivering the highest level of economic welfare to the people in the country that we can," said Fuhrer. "The first thing that matters to people is whether they have a job, that it pays well, and that it is rewarding."

The attention to jobs aligns with the Fed's dual mandate – to promote maximum employment and stable prices – but Fuhrer recognizes there are limits to what the Fed can do. "We can't control the quality of jobs being offered… but we're always thinking 'those are real people out there.' And the welfare loss from unemployment is significant."

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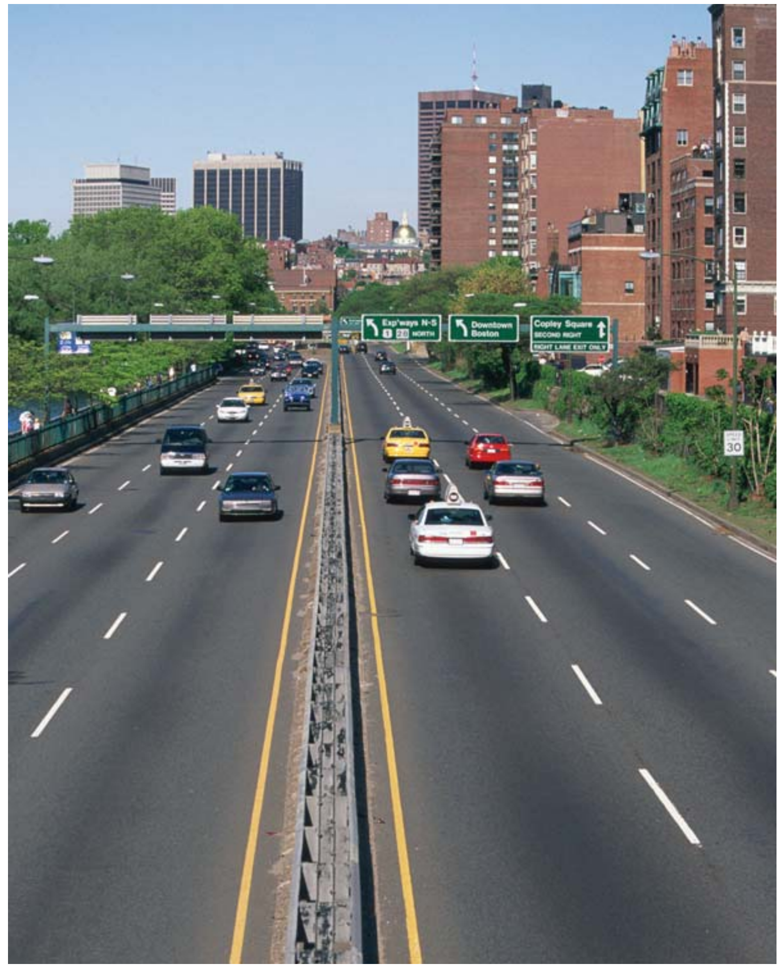
In a year of new challenges, tackling these issues required creative efforts from the start. "It's important to recognize that it's very, very hard to tell from the first few months of data what the year is going to be," said Fuhrer. "Last year, there was extreme weather." From record snowfalls and ice storms in the United States to the devastating earthquake and tsunami and Japan, the nation's predicted economic recovery hit a speedbump.

"We had a burst of growth and a strong employment expansion in the beginning of 2011, but it subsided quickly," said Senior Vice President and Director of Research Geoff Tootell, noting the questions that emerged from those early months: "Did it subside due to debt crisis here and abroad, or was it subsiding before that? Was it a blip, a false signal? The early part of 2011 reminds us all that 4 months of good data does not a real recovery make."

With unemployment rates stubbornly high and growth in the first half of 2011 meager, it was time for action. Once it became clear that the recovery was proceeding at a subpar pace, the Federal Reserve Open Market Committee wasted no time in responding.

At the time, the Fed owned more than $1 trillion in Treasury bills and bonds, many of which were short- to medium-term bills and bonds set to come due in the next few years. In an effort to reduce longer-term interest rates without swelling the size of the Fed's balance sheet, the Committee elected to sell some of the shorter-maturity securities, using the proceeds to buy longer-term Treasury securities, pushing their yields down. This measure, known as "Operation Twist,"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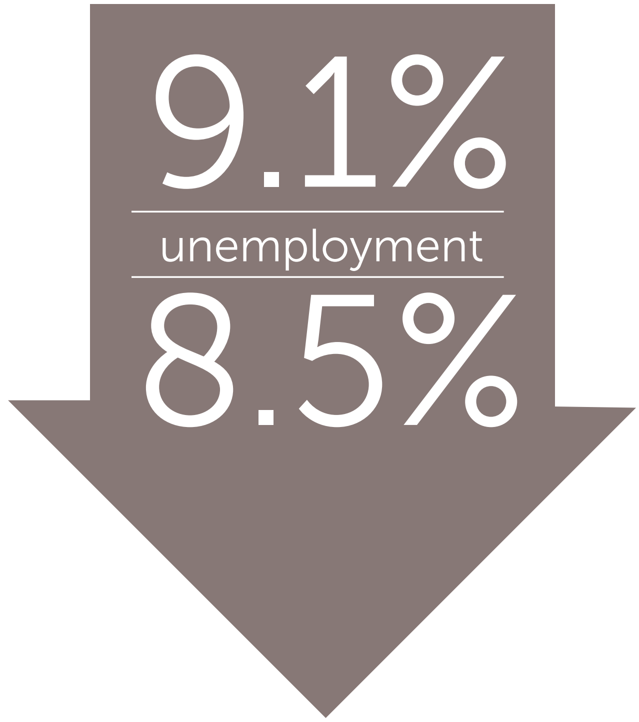
reduced the supply of desirable longer-term bonds available to the private markets, raising their prices and lowering their yields. Importantly, investors see other financial products of similar maturity and risk, such as highly-rated mortgages and business loans, as good substitutes for Treasury bonds. Thus when the rates on Treasuries were affected by Operation Twist, so were other interest rates that more directly affect borrowing and spending in the economy, including mortgages, auto and business loans.

Why push interest rates even lower? For every $500 to 700 billion of securities purchased, the Boston Fed estimates that we were able to save 500,000 to 700,000 jobs; protecting the economic welfare of 500,000 to 700,000 individuals and families, said Fuhrer. To those families, he suggests, that policy made a significant difference.

This measure ultimately could not provide a full recovery, but Boston Fed economists remain upbeat. "A policy action that, for instance, reduces the unemployment rate by half a percent over time will not return the economy to full employment, of course, but will still mean 750,000 jobs that would not have been created in the absence of the action," Boston Fed President Eric Rosengren said at the time, unwilling to settle for the unacceptable 9.1% unemployment rate.

Of course, no one can be certain how much of an outcome derives directly from monetary policy actions. "It is very difficult, in real time, to know how much of an effect any of our actions have on the economy because of other factors," said Fuhrer, pointing to the extreme weather conditions, a political debate on the debt ceiling that shook Washington, D.C., and international economic disruptions that made US Treasuries a more attractive investment. But in the second half of 2011, an unexpected bright spot developed: despite rather meager economic growth, unemployment rates began to fall, more than people



expected. By December of that year, unemployment would reach a 3-year low 8.5%.

Shortly before announcing Operation Twist, the Committee made another major change in its operations that didn't involve sales or purchases. At its August meeting, the Committee established a specific, though non-binding, horizon for holding interest rates near their zero bound. This transparent communication likely reduced some of the speculation swirling around markets at the time: what was once a guessing game for market-watchers became a clearer guide for participants, a bold statement in a weak economy.

Transparency alone would not resolve the pressing economic issues. Several economists pointed to structural unemployment as the source of problems. At the Boston Fed, these claims did not go unheard. "It's too easy to be cavalier about that claim," said Fuhrer. "People say, 'there's not that much structural unemployment, it can't be that all of that is structural.' You can dismiss that out of hand, but that wouldn't be the most responsible way of thinking about it." Aware of the risks of overlooking a potential threat, Boston Fed researchers analyzed the data bearing on structural unemployment hypotheses. "They looked at whether there was evidence of regional or skill-based or sector mismatch by looking at data on job openings and unemployment by region, by industrial sector, and to the extent they can, by skill level," explained Fuhrer. "It turns out it's very hard to see much evidence of structural unemployment in the data."

Numerical data alone do not guide Fuhrer in his professional life. As Executive Vice President of the Bank's Regional and Community Outreach division, he shares his time between monetary policy and the issues facing low- and moderate-income populations in the region. Working with partner entities and advisory councils, he has a view both inside and outside the Fed building.

"We are trying to figure out what's going on in the world and how what we do is affecting them. For the most part that is about monetary policy, but it's not only that. It's also about the things we do in community development and community outreach."

At no point does Fuhrer lose sight of the purpose behind this research. In fact, it has guided his career from the start: "It's pretty clear from the top down that we're here to do a public service. That's why I went into economics."

Related Links

- Research and Data at the Boston Fed
  http://www.bostonfed.org/economic/index.htm

- Boston Fed's Summary of National Economic Data
  http://www.bostonfed.org/economic/natldata/index.htm

- Jeff Fuhrer's Biography and Research
  http://www.bostonfed.org/economic/econbios/fuhrer.htm

- The Estimated Macroeconomic Effects of the Federal Reserve's Large-Scale Treasury Purchase Program
  http://www.bostonfed.org/economic/ppb/2011/ppb112.htm

- Credit and Liquidity Programs and the Balance Sheet
  http://www.federalreserve.gov/monetarypolicy/bst_fedsbalancesheet.htm

- FAQs on the Federal Reserve's Maturity Extension Program ("Operation Twist")
  http://www.federalreserve.gov/faqs/money_15070.htm

- The Federal Open Market Committee (FOMC)
  http://www.federalreserve.gov/monetarypolicy/fomc.htm

- The Federal Reserve Act
  http://www.federalreserve.gov/aboutthefed/fract.htm

- Federal Reserve Economic Data
  http://research.stlouisfed.org/fred2/