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Economics Group

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Has the Fed's Unconventional Approach Been Successful?

With economic growth projected to remain below trend for at least the next two years and the Federal Funds Target Rate at its lower bound, unconventional monetary policy has become commonplace, but is it effective?

Is Three Times a Charm?

With recent hints from FOMC members of a third round of quantitative easing, there has been much discussion about the effectiveness of the Federal Reserve's unconventional approaches to monetary policy thus far. After cutting the federal funds target rate to its lower bound, the Fed has implemented three unconventional approaches to spur economic growth. The first two methods, called large-scale asset purchases (LSAP) or "quantitative easing", increased the size of the Fed's balance sheet by buying treasuries, agency debt and mortgage-backed securities. To be sure, the intent of LSAP was to buy assets with medium and long-term maturities, which should remove duration from the market and lower long-term yields. The latest approach, "Operation Twist", was crafted to sell securities with short maturities and purchase securities with longer-term interest rates, which would flatten the yield curve. That said, with lower returns, there should be some spill over effect where investors bid up the prices of other assets, such as equities, in search of higher returns.

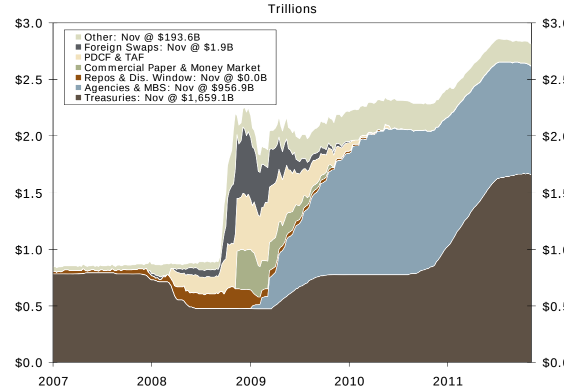
Well, Did it Work?

Since the initial LSAP announcement on Nov. 25, 2008 when the 10-year Treasury yield was 3.11 percent, rates rose to a peak of 4.01 on April 5, 2010, but later fell to a low of 1.72 percent on Sept. 22, 2011. With the peak surpassing the rate on the initial day of announcement, some investors may suggest unconventional methods in aggregate were unsuccessful. On the contrary, based on three key dates (QE1 announcement—Nov. 25, 2008; QE2 hint at Jackson Hole—Aug. 27, 2010; Operation Twist hint—August 9, 2011 FOMC Meeting Minutes), it appears that the Fed's unconventional approach to monetary policy helped pull rates lower on average by 50 basis points, reaching a low 24 days following the announcement/hint. For Operation Twist, the 10-year Treasury yield reached a historic low of 1.72 percent on Sep. 22, 2011, the day following the FOMC announcement. This suggests the markets had priced in Operation Twist prior to the official announcement—a common event with monetary policy decisions. That said, monetary policy can not easily be evaluated *ceteris paribus* as many other factors influence interest rates. The downward trajectory of long-term rates is thrown off its path by outside shocks (e.g. debt ceiling debate, euro zone sovereign debt crisis, weak economic data), which then cause investors to move back into the safety of Treasuries, thereby pushing the long-term yield higher (risk on/risk off trade).

It also seems the Fed's unconventional approach spilled over to equity markets in the short run, pushing the S&P 500 higher by an average of 37 points to a local peak five days following the announcement/hint. We can assume that monetary policy has been effective, but on a daily basis, investor sentiment and headline risks seem to override any momentum.

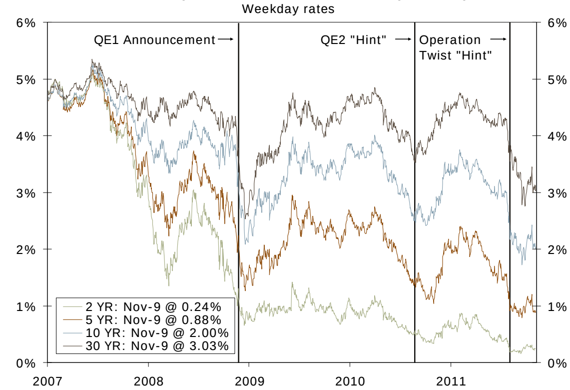
Federal Reserve Balance Sheet

Trillions



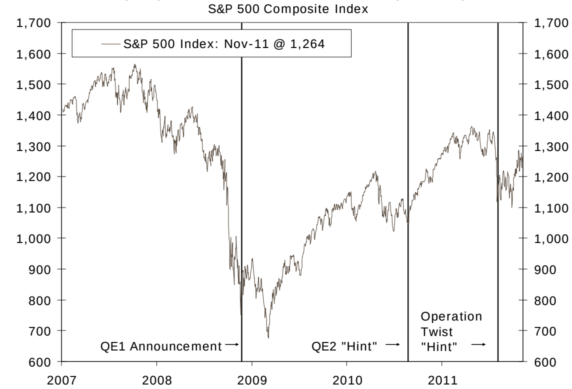
Treasury Yields and Monetary Policy

Weekday rates



Equity Markets and Monetary Policy

S&P 500 Composite Index



Source: Federal Reserve Board, Standard & Poor's and Wells Fargo Securities, LLC

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