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GRADING THE FED'S QE PROGRAM: WEEK 2

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KEY TAKEAWAYS

With six months of economic and market data since the end of QE, we assess the latest round of the program that ended in October 2014.

We focus on the Fed's dual mandate to promote low and stable inflation and maximum employment.

We give the Fed a pass on the unemployment rate, but have to assign a failing grade on its progress with inflation.

We gave the Federal Reserve's (Fed) quantitative easing (QE) a passing grade for lowering financial market and banking stress levels in last week's *Weekly Economic Commentary*, "Grading the Fed's QE Program: A Multi-Week Group Project," May 18, 2015). Why grade the Fed now? We have just passed the six-month mark from the last purchase of QE3, which began in September 2012 and ended in October 2014. Also this week, colleges, universities, and high schools pass out report cards and hand out diplomas, so we'll grade the Fed on its dual mandate—granted to the Fed by Congress in 1977—to promote low and stable inflation and maximum employment.

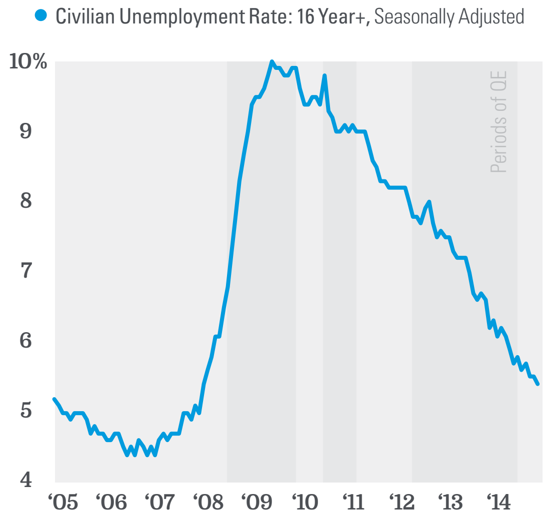
OUR SCORECARD: INFLATION & EMPLOYMENT

As part of our grading process, we'll compare the performance of inflation and employment before, during, and notably, six months after the end of Q3; as well as before, during, and after the Fed's first two forays into QE: QE1 (November 2008 through March 2010) and QE2 (November 2010 through June 2011). We'll complete the grading in the next *Weekly Economic Commentary* by assessing the performance key sectors of the financial market—a key transmission mechanism for QE from the Fed to the rest of the economy. As we assess the Fed, we point out that Operation Twist came between QE2 and QE3, making it much more difficult to grade either of them on their own merits. Operation Twist was aimed at putting downward pressure on long-term Treasury yields without the Fed buying any additional net Treasures. It sold existing holdings of short-term Treasuries (less than three-year maturity) and bought longer-term Treasuries (6–30 years in maturity).

The Fed cannot control either inflation or employment directly of course, and can only use its policy tools to foster an economic environment that will lead to low and stable inflation and maximum employment. For most of its history, the Fed used some combination of the money supply, reserve requirements (money the Fed requires banks to hold against their deposits), and interest rates to nudge the economy toward the goals of the Fed's dual mandate. However, in December 2008—in the aftermath of the collapse of Lehman Brothers and the near freeze-up of the global credit markets—the Fed cut its fed funds rate to zero and began pursuing bond purchases, or QE, to achieve its goals.

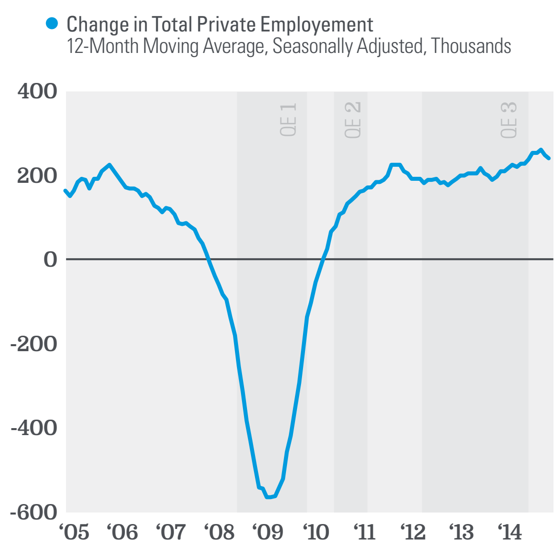
Although classroom textbooks and academic theory can help us understand the "real world," the real world itself is much messier. The Fed's policy actions do not occur in a classroom, they happen in a dynamic global economy, where economic decisions and policy actions in Taiwan, Turkmenistan, and Tunisia often dictate what happens in Toledo, Texarkana, and Topeka. So while we are grading the efficacy

1 **QE WAS EFFECTIVE IN LOWERING THE UNEMPLOYMENT RATE...**



Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 05/21/15

2 **...AND BOOSTING THE LABOR MARKET**



Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 05/21/15

of the Fed's policy actions, in reality it is extremely difficult to determine the success or failure of Fed policies, let alone a grade, without taking into account that the Fed is only one factor—albeit a very important one—influencing the real economy.

Keeping this in mind, we will look at two metrics for each side of the Fed's dual mandate.

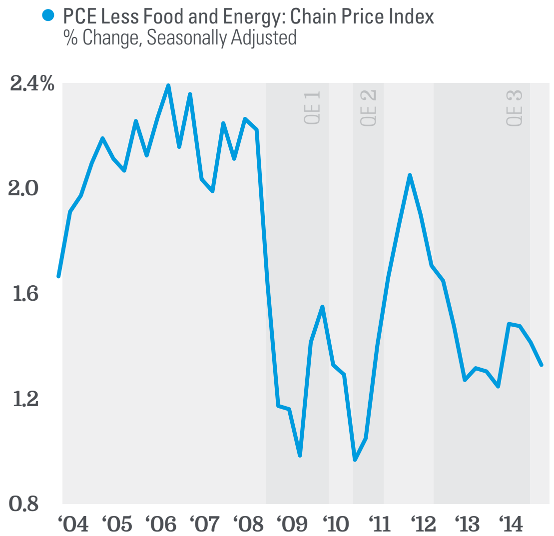
- On the "maximum employment" side, we'll examine the unemployment rate and job creation.
- On inflation, we will examine the personal consumption expenditure (PCE) deflator excluding food and energy, commonly known as core PCE, and inflation expectations as measured by the Philadelphia Fed's Survey of Professional Forecasters.

UNEMPLOYMENT RATE: PASS

First up is the unemployment rate, although it is not the only metric the Fed looks at to assess the labor market's path toward full employment. (For more on the Fed's labor market indicators, see the latest *Portfolio Compass*, May 20, 2015). While not the perfect measure of the health of the labor market, Fed officials have indicated that if you only look at one metric to gauge the labor market, the unemployment rate is the best. When QE1 began in November 2008, just two months after the collapse of Lehman Brothers, the unemployment rate stood at 6.8% [Figure 1]. But because the labor market is a lagging indicator of economic activity, the rise in the unemployment rate from its prerecession low of 4.4% was not over yet. By October 2009, 11 months into QE1, the unemployment rate hit 10.0%; but by the end of QE1 in March 2010, it had dropped back to 9.9%. In September 2010, six months after QE1 ended, the unemployment rate had dropped further to 9.5%, but was still well above where it was when QE1 started.

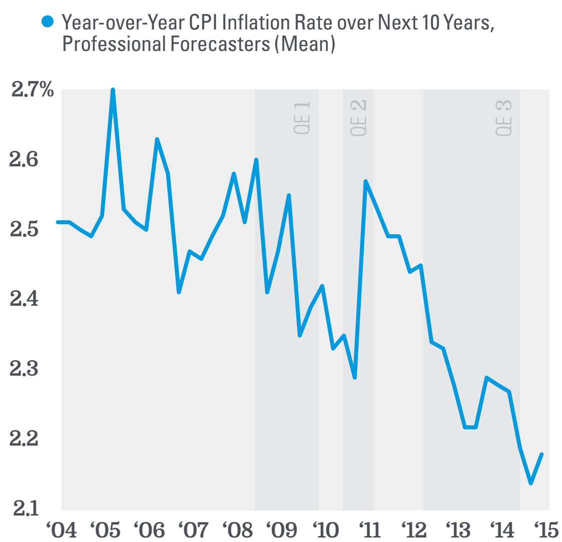
While the unemployment rate varied over the course of QE1, it consistently fell as QE2 and QE3 unfolded, most dramatically during QE3, when the rate fell from 7.8% at the start of QE3 (September 2012) to

3 **THREE ROUNDS OF QE FAILED TO RAISE INFLATION...**



Source: LPL Research, Bureau of Economic Analysis, Haver Analytics 05/21/15

4 **...OR INFLATION EXPECTATIONS, AS OUTSIDE FACTORS OFFSET FED PURCHASES**



Source: LPL Research, Federal Reserve Bank of Philadelphia, Haver Analytics 05/21/15

5.7% by the end (October 2014). Today, six months later, the unemployment rate stands at 5.4%, below the 6.8% rate in November 2008 when QE1 started. So did the unemployment rate decline over the course of QE? Yes—but the question is, would the unemployment rate have fallen without the help of QE? Looking back over the post-WWII period, the unemployment rate always falls after the end of a recession; however, those declines in the unemployment rate were accompanied by Fed rate cuts. With the fed funds rate at zero in late 2008, the Fed couldn't cut rates this time around, and used QE instead. Thus, we give the Fed a passing grade for lowering the unemployment rate with QE.

JOB CREATION: PASS

Our second metric in this week's report card is job creation [Figure 2]. We looked at the average number of private sector jobs created per month, over the prior 12 months as QE began, when QE ended, and six months after QE ended. In each of the three rounds of QE, job creation improved between the start and the end of QE, and from the end of QE through six months after. Overall, when QE began in November 2008, the economy had shed an average of 402,000 jobs per month over the prior 12 months. Today, six months after the end of QE3, the economy has created an average of 251,000 jobs per month in the 12 months ending in April 2015. Looking back over the post-WWII period, the pace of job creation always improves from the depths of a recession. So did QE really help? Here again, cutting rates (which the Fed did during and after every post-WWII recession) was not an option, and the Fed did QE instead. In short, the Fed followed its playbook, and gets a passing grade for boosting the labor market with QE.

INFLATION: FAIL

So far, so good, but the final exam is only halfway over. Although the Fed was generally successful in moving the economy toward maximum employment with QE, it has thus far failed in its efforts to promote stable inflation. In the 1960s, 1970s, 1980s, and 1990s, the Fed's concern was keeping a lid on runaway inflation. Since the late 1990s—and especially since the Great Recession—the Fed's battle has been against deflation, a prolonged period of falling wages and prices. In Figures 3 and 4, it's clear that despite successive rounds of QE over a six-year period, the Fed was not able to push up inflation [Figure 3] or inflation expectations [Figure 4]. Both metrics remain well below where they were when QE1 began in November 2008, despite substantial improvement in the U.S. labor market, U.S. financial and banking system, and U.S. economy at large. So has QE failed?

In the classroom QE is expected to push inflation and inflation expectations higher, and for brief periods since QE1 began in 2008, inflation and inflation expectations did move higher. Today, we see that the Bank of Japan's QE program is starting to push inflation and inflation expectations in Japan higher, and the Eurozone's QE program (which began in March 2015) is also pushing inflation and inflation expectations higher. But while major central banks fought against deflation with QE, other factors outside or at the periphery of their control continued to push down on inflation. There are signs that those forces are beginning to abate, and an argument can be made that inflation may be even lower today, had the Fed and the other central banks not acted. Still, we have to give the Fed a failing grade on inflation.

Next week, we'll grade the Fed's QE program on how it impacted financial markets, one of the Fed's key transmission mechanisms to achieve its dual mandate. ■

DEFINITIONS

Quantitative easing (QE) refers to the Federal Reserve's (Fed) current and/or past programs whereby the Fed purchases a set amount of Treasury and/or mortgage-backed securities each month from banks. This inserts more money in the economy (known as easing), which is intended to encourage economic growth.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Personal Consumption Expenditures (PCE) is a measure of price changes in consumer goods and services, targeted toward goods and services consumed by individuals. PCE is released monthly by the Bureau of Economic Analysis (BEA).

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