U.S. Fed Flash

Bernanke Highlights Policy Options in Jackson Hole Speech

- **Comments addressed prior successes of balance sheet and communication tools**
- **Two rounds of QE and OT have lowered long-term rates, increased output, and increased employment in the private sector**
- **Bernanke revealed no commitment to announce QE3 in September FOMC meeting**

Ben Bernanke's speech at the Jackson Hole Economic Symposium did not meet market expectations in the form of a QE3 announcement. Instead, the Chairman discussed in depth the Fed's actions since the recession and the costs and benefits of additional accommodation. Bernanke acknowledged that the central banks have limited historical experience in implementing nontraditional monetary policies such as large-scale asset purchases but gave more detail regarding what he thinks about the performances of these tools until now. First, Bernanke commented on the effectiveness of balance sheet tools that the Fed has utilized, noting that the two rounds of quantitative easing and Operation Twist have lowered 10-year Treasury yields between 80 and 120 basis points, an effect that is "economically meaningful". He also mentioned that the expansion of securities purchases just shortly after the recession likely influenced the recovery of equity prices in March 2009, influencing both consumption and investment activity and lowering the risk of deflation by increasing inflation expectations. He also mentioned that LSAP improved the functioning of financial markets and eased credit condition in certain sectors. According to the Fed's models of the US economy, the two rounds of quantitative easing have increased output by almost 3% and helped add more than 2 million jobs in the private sector. Bernanke also pointed out that these nontraditional monetary policies were not that successful in affecting the housing market due to restrictive mortgage underwriting standards.

Bernanke also highlighted the Fed's communication tools, referring to the policy guidance as an appropriate "path of policy" rather than "an unconditional promise". Currently, the FOMC expects rates to be exceptionally low through "at least late 2014", but Bernanke provided reasons for possibly extending this guidance. He argued that it might be necessary to "keep rates low for a longer time than implied by policy rules developed during more normal periods", pointing to a cautious interest rate policy.

In addition, Bernanke discussed the costs and benefits of nontraditional monetary policy tools such as LSAPs, with various costs seemingly manageable in order to reach the potential benefit of better economic outcomes. These costs included potential damage to securities markets, reduced confidence regarding the Fed's ability to exit smoothly, risks to financial stability, and the possibility of financial losses by the Fed if interest rates rise more than expected. While he made it clear that the decision to implement non-traditional tools is less clear-cut compared to more traditional options, the Fed is ready to act and use nontraditional monetary tools if economic conditions warrant.

Finally, he talked about economic prospects. Bernanke believes that the unemployment rate will eventually return to its pre-crisis level and sees "little evidence of substantial structural change in recent years". However, if high levels of unemployment persist, it would "wreak structural damage on our economy that could last many years."

Overall, the Chairman's conclusions were not a dead giveaway for what the FOMC is likely to announce in the September meeting. As in prior statements, he emphasized the major headwinds facing the economic recovery: weak housing activity, fiscal policy, tight credit conditions, and financial strains related to Europe. He mentioned, as in previous speeches and communications, that the fiscal cliff is a potential risk to growth in the short-term and Congress should "avoid a sharp near-term fiscal contraction" while solving medium- and long-term fiscal issues. Bernanke mentioned again that the Fed "will provide additional policy accommodation as needed", but he hinted at no commitment to taking action in September. Based on his comments today as well as recent macroeconomic news, we expect that the FOMC is more likely to announce an extension of policy guidance rather than additional quantitative easing, unless the employment report is significantly worse than expected for August.

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