Federal Reserve intensifies effort to improve labour market

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The Fed has completed a major shift in its monetary policy by committing to unemployment and inflation thresholds that have to be met before monetary policy will be tightened. This caps a remarkable transition in the Fed's strategy for boosting the economic recovery, but also moves US monetary policy firmly into untested territory.

In its most unorthodox policy move since the financial crisis began, the Fed on December 12th tied its interest rate policy to a specific unemployment target. The US central bank will now keep its official interest rate at the current, extremely low level of 0-0.25% until the unemployment rate falls to 6.5%. This is a clear move away from the previous strategy of managing interest rate expectations through the communication of expected dates for monetary tightening. This commitment to a labour market objective is unprecedented in Fed history and completes the shift in US monetary policy away from inflation targeting towards an employment goal. The Fed had already started this transition when it announced its open-ended bond-buying programme, a third round of quantitative easing (QE3), in September 2012, which already featured a general focus on an improvement in the labour market. However, the latest announcement, tying interest rates to specific labour market outcomes, is highly unusual and takes the Fed into uncharted territory in monetary policy terms.

Institutional focus shifts from inflation to employment

The Fed has long had a dual mandate to ensure both price stability and full employment, but its institutional focus until recently has been more on inflation than the labour market. However, as the economic recovery since 2009 has remained comparatively weak, the central bank has come under political pressure to do more to alleviate high joblessness. The latest policy move reflects this. The change in the central bank's focus has taken some time to execute, and the Fed chairman, Ben Bernanke, is believed to have been the driving force in the conversion. That said, the Fed's statement hints at the compromises required to obtain the backing of most monetary policy committee members: alongside the unemployment target, the Fed has also committed to observing a second threshold relating to price stability—namely, that core inflation should not exceed 2.5% over a 1-to-2-year time horizon. In theory, this is supposed to prevent a continuation of easing when inflation threatens to rise substantially above the Fed's preferred target of 2%. In practice, though, this formulation gives the Fed considerable latitude to ignore bursts of inflation that rise above the threshold, particularly as it will judge itself by its own internal forecasts. Even so, we do not think that the Fed would be prepared to tolerate an extended period of inflation above 3%.

Balance sheet expansion accelerates, as date-based guidance is abandoned

The magnitude of the shift in the Fed's approach becomes clearer from other changes announced in the December statement. The Fed has largely withdrawn the date-based guidance on interest rates that had become common in recent monetary policy communications. Previously, the Fed's view was that interest rates were likely to remain at extremely low levels until mid-2015, reflecting policymakers' belief that the economic recovery would require monetary stimulus for an extended period of time. That date-based language has now been removed from the statement and replaced by the unemployment target. The Fed's latest economic projections suggest that it believes the new unemployment target will not be reached until 2015 in any case, but this is still a remarkable shift.

The Fed is also raising the pace of its balance sheet expansion with the latest changes. Its December statement shows that the monetary policy committee remains dissatisfied with the pace of economic recovery—growth, inflation and unemployment projections remain off-target. As a result, the Fed is also committing to an expansion of a bond-buying programme it began in September 2012—a third round of quantitative easing known as QE3. The Fed will now buy public-sector bonds worth US$85bn per month, using newly created funds. This marks an expansion from the current pace of US$40bn of new monthly purchases, to compensate for the completion of a pre-existing programme that rotated the Fed's short-term holdings into longer-term bonds ("Operation Twist"). Together, QE3 and the balance sheet rotation had accounted for US$85bn of long-term bond purchases per month, and the Fed clearly wanted to preserve this degree of monetary accommodation with the latest changes. The bond purchase programme remains open-ended, an innovation introduced just three months ago; this is intended to guide expectations of market participants that the Fed will keep monetary policy accommodative for as long as it takes to achieve its economic (and specifically, monetary policy) objectives.

Fed's new policy is untested

There is still considerable uncertainty surrounding the effectiveness of the Fed's new and untested approach. The unemployment rate may prove to be an unreliable measure of the economic recovery, just as a focus purely on consumer-price inflation proved to be inappropriate in many countries before the financial crisis began. Moreover, as it is too soon to gauge the impact of the Fed's policy change in September 2012, it seems premature to be shifting strategy again. Yet, Fed policymakers, led by Mr Bernanke, have become frustrated with the pace of recovery and are becoming more open to new ideas. Other central bankers, notably the incoming Bank of England governor, Mark Carney, have cautiously endorsed alternative monetary policy targets, such as a nominal GDP level target. Assuming the US economy does not experience the severe fiscal tightening scheduled for 2013—and the Economist Intelligence Unit's forecast is that this "fiscal cliff" will be substantially moderated—there is a chance that unemployment could continue to fall at the existing pace of around 0.7-1 percentage point per year. This would bring the target unemployment rate within reach by around mid-2014. At that point, the Fed could put a stop to further easing. That, however, is the benign scenario. With this latest, very bold move, the Fed has opened itself to heavy criticism if the new strategy does not deliver—or worsens the unemployment outlook. That the Fed has taken that risk reflects the seriousness with which it is treating this extended period of unemployment.