

TOPICAL RESEARCH AND HIGHLIGHTS

MONETARY POLICY NORMALISATION IN THE UNITED STATES

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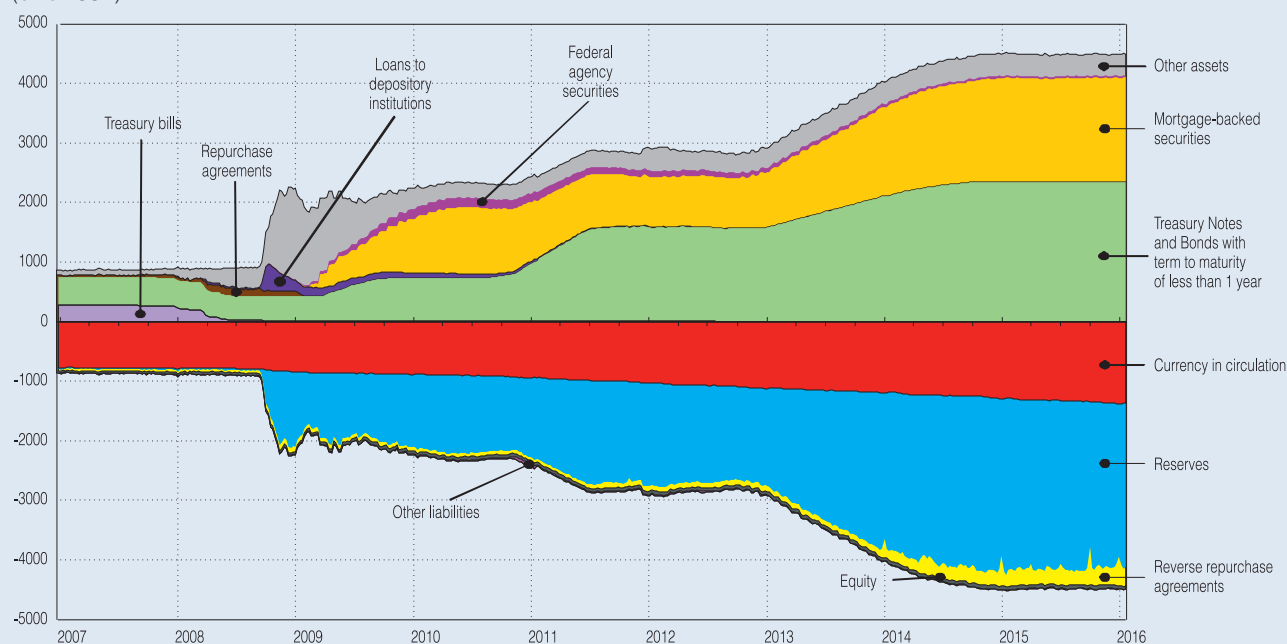
BULGARIAN NATIONAL BANK

Monetary Policy Normalisation in the United States

The economic recession in the United States which started at the end of 2007 and continued until mid-2009¹ has brought about significant changes in the Federal Reserve's monetary policy. Between December 2007 and October 2014, the US Federal Reserve System has undertaken a series of standard and non-standard monetary policy measures. The standard expansionary monetary policy measures started with the cut of the target federal funds rate in September 2007. The downward trend in the Federal Reserve's main interest rate continued just over a year. The latest cut was made in December 2008 by setting the official federal funds rate target at a range of 0 to 0.25 per cent, where it remained unchanged until December 2015. This is the longest period of keeping the target rate at such a low level after the restoration of the Federal Reserve Systems' independence in 1951. The rapid depletion of the effectiveness of standard monetary policy measures against the background of the ongoing economic recession in the US called for the introduction of non-standard monetary policy measures, among which asset purchase programmes or the so called quantitative easing², the first of which was announced by the Federal Reserve at the end of November 2008. Over the period in which the Federal Reserve conducted non-standard monetary policy measures, its balance sheet figure saw a five fold increase. Most of this increase was realised after the end of the recession and was the result of the Federal Reserve System's desire to fulfil its mandate to return the economy to full employment and achieve price stability.

Composition of the Federal Reserve Systems' Balance Sheet

(billion USD)



Source: Federal Reserve System of the USA

Following the significant improvement in the US labour market conditions over the recent years and the confidence of the members of the Federal Open Market Committee (FOMC)³ that the Federal Reserve Systems' inflation targets will be reached soon, at its meeting of 16 December 2015 the Committee decided unanimously to commence the process of normalisation of the US monetary

¹ According to the definition of recession by the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER).

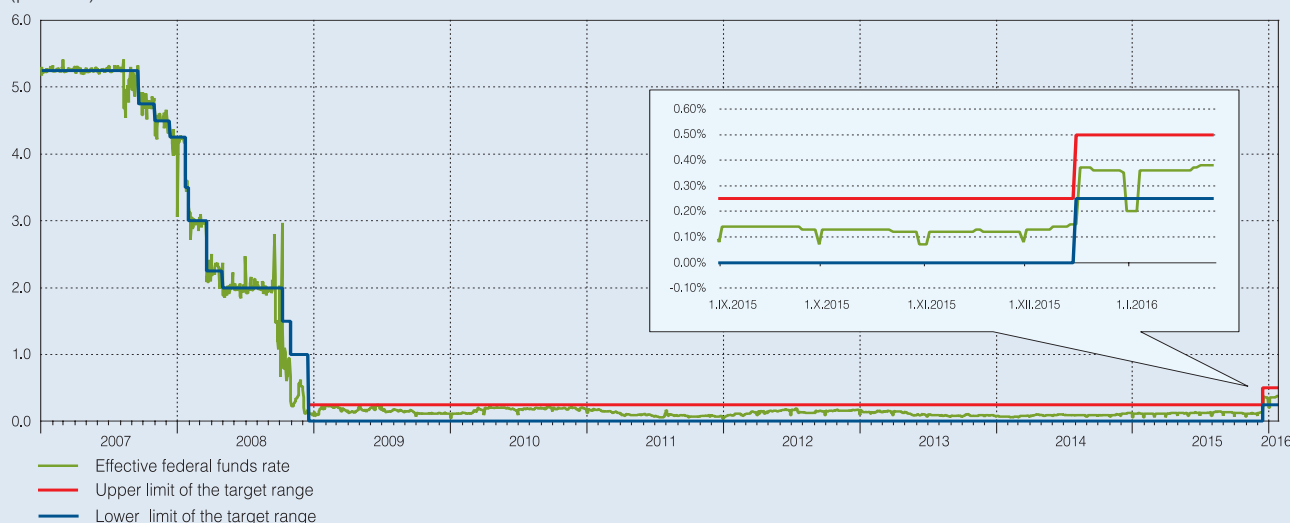
² For more information on the Federal Reserve Systems' measures in response to the financial crisis see the Federal Reserve System's website: <http://www.federalreserve.gov/monetarypolicy/bst.htm>

³ The Federal Open Market Committee is the main monetary policy body of the Federal Reserve System.

policy by raising the target range for the federal funds rate by 0.25 percentage points to 0.25 – 0.50 per cent.

Target and Effective Federal Funds Rates

(per cent)



Source: Federal Reserve Bank of St. Louis

The process of normalisation of the monetary policy is a sequence of actions whose implementation will allow the Federal Open Market Committee (FOMC) to implement monetary policy in the same way it did before the outbreak of the financial crises in 2007.⁴ This sequence of actions is described in the 'Policy Normalization Principles and Plans'⁵ published in September 2014. It presents an updated detailed plan⁶ whose implementation may be divided into two stages overlapping in time.

The first stage of normalizing the stance and conduct of monetary policy provides for a gradual increase in the target range of the federal funds rate to more normal levels. According to the plan, the timing and rates of increase in the target federal funds rate and other short-term interest rates will depend on the information received on the US economic conditions and outlook. Under the plan of September 2014 and the details on its implementation published in 2015, the current interest rate corridor of 25 basis points will remain unchanged and the upper limit of this corridor will be determined by the interest on the excess reserves of depository institutions with the Federal Reserve, while the lower limit will be determined by the interest rate that will be paid by the Federal Reserve on the instrument for conducting overnight reverse repurchase operations⁷. The overnight reverse repurchase operations tool⁸ will be used, as not all financial institutions participating in the US money market have the right to receive interest on their excess reserves held with

⁴ For further information concerning the normalisation process see the Federal Reserve System's website: <http://www.federalreserve.gov/monetarypolicy/policy-normalization.htm>

⁵ Minutes of the FOMC meeting of 16-17 September 2014. See <http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20140917.pdf>

⁶ The first plan to provide general guidelines on the process of normalisation of the US monetary policy was published in the Minutes of the FOMC of the 21-22 June 2011 meeting under 'Exit Strategy Principles'. See: <http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20110622.pdf>

⁷ For monetary policy purposes, this instrument was adapted for use by a wider range of participants in the overnight money market.

⁸ For more information on the *modus operandi* and the effects of the application of this instrument see: 'Overnight RRP Operations as a Monetary Policy Tool: Some Design Considerations', Finance and Economics Discussion Series 2015-010. Frost, Josh, Lorie Logan Antoine Martin, Patrick McCabe, Fabio Natalucci, and Julie Remache (2015). Washington: Board of Governors of the Federal Reserve System, <http://dx.doi.org/10.17016/FEDS.2015.010>.

the Federal Reserve System⁹. Setting an upper and a lower limit of the interest rate paid by the Federal Reserve to the market participants, entitled or not entitled respectively to receive interest on their excess reserves, will create incentives for interest arbitrage in lending and borrowing of funds between them. Thus, if there is enough competition between money market participants, the effective federal funds rate¹⁰ should move near the middle of the corridor. Currently, the Federal Reserve System foresees to cease the use of the overnight reverse repurchase operations as a monetary policy instrument when it is no longer needed to control the federal funds rate.

The second stage of the process of normalisation of the US monetary policy provides for a gradual and predictable decrease in the Federal Reserve System's balance sheet. This stage will be realised mostly by terminating the current policy for reinvestment of the proceeds from the maturing securities in the Federal Reserve's portfolio. The process of termination will start after the initial increase of the target interest rate and the point where the reinvestment policy will be phased out will depend on the economic and financial conditions, as well as the US economic outlook. Currently, the members of the FOMC do not foresee any sales of agency mortgage-backed securities, as part of the process of normalisation, although in the long run small sales may be possible to decrease or remove the residues of those securities from the Federal Reserve's balance sheet. In the long run, the members of the Committee intend to keep the volume of securities on the Federal Reserve's balance sheet no greater than necessary for the effective and efficient implementation of the monetary policy, and foresee to limit the securities in the central bank's portfolio mainly to US treasuries. This will minimise the possible negative effects on the distribution of credit in the different sectors of the economy.

Currently, the economists to the Board of Governors of the Federal Reserve expect the entire monetary policy normalisation process in the USA to last about seven years¹¹. Given that the normalisation process details are subject to changes related to the economic and financial developments in the USA, this is an estimate period.

⁹ An up-to-date list of all counterparties that may participate in reverse overnight repurchase operations with the Federal Reserve can be found on the website of the Federal Reserve Bank of New York: https://www.newyorkfed.org/markets/expanded_counterparties.html

¹⁰ For more information on the effective federal funds rate see the website of the Federal Reserve Bank of New York: <https://apps.newyorkfed.org/markets/autorates/fed%20funds>

¹¹ See Williamson S. (2015). 'Monetary Policy Normalization: What's New? What's Old? How Does It Matter?', Presentation of the Vice President and Economist Federal Reserve Bank of St. Louis, slide 33, 28 May 2015

THE SCULPTURAL COMPOSITION BY KIRIL SHIVAROV DEPICTING HERMES AND DEMETER ON THE SOUTHERN FAÇADE OF THE BULGARIAN NATIONAL BANK BUILDING IS USED IN COVER DESIGN.