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Is This Time Different for Monetary Policy?

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Abstract

With the stage set for a rapid economic rebound, analysts are wondering if this time is different for monetary policy. Specifically, is this the end of the declining cycle peaks in the Fed Funds Rate (FFR)? Will the FOMC deviate from the trend of offering larger incentives for a longer duration? This study develops a new framework to shed light on the near-term path of monetary policy.

The first step estimates the magnitude of the monetary stimulus offered during different business cycles, and suggests that the FOMC has offered larger incentives for a longer duration in each recession relative to the prior cycle by exhausting its traditional tools and utilizing less conventional tools. Each recession has drained the FOMC's resources and left the Committee with fewer conventional tools to fight the next recession.

The estimated duration of monetary stimulus for the current cycle may be shorter than the past cycle, though the estimated magnitude of the current monetary stimulus has already crossed the previous cycle's bar. The second step suggests that the FFR may follow the past declining trend in the near future. That is, the near-term peak in the FFR may be lower than the past cycle's peak value. Essentially, lower rates and a larger balance sheet are here to stay.

The final step characterizes the pace of the current recovery and compares it to the past recoveries. The current recovery is likely to break the past weaker-recovery trend. A faster recovery, along with higher inflation, may break the past declining FFR. However, given the second step's prediction of a lower FFR peak value in the near future, we caution that policymakers should not be exclusively influenced by the faster recovery and higher inflation. We strongly recommend monitoring the upcoming data to analyze whether this time is different enough to start a different path for monetary policy.

Key Words: Monetary Policy; Effectiveness; Business Cycles; Different Time.

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