



Lessons from the Taper Tantrum

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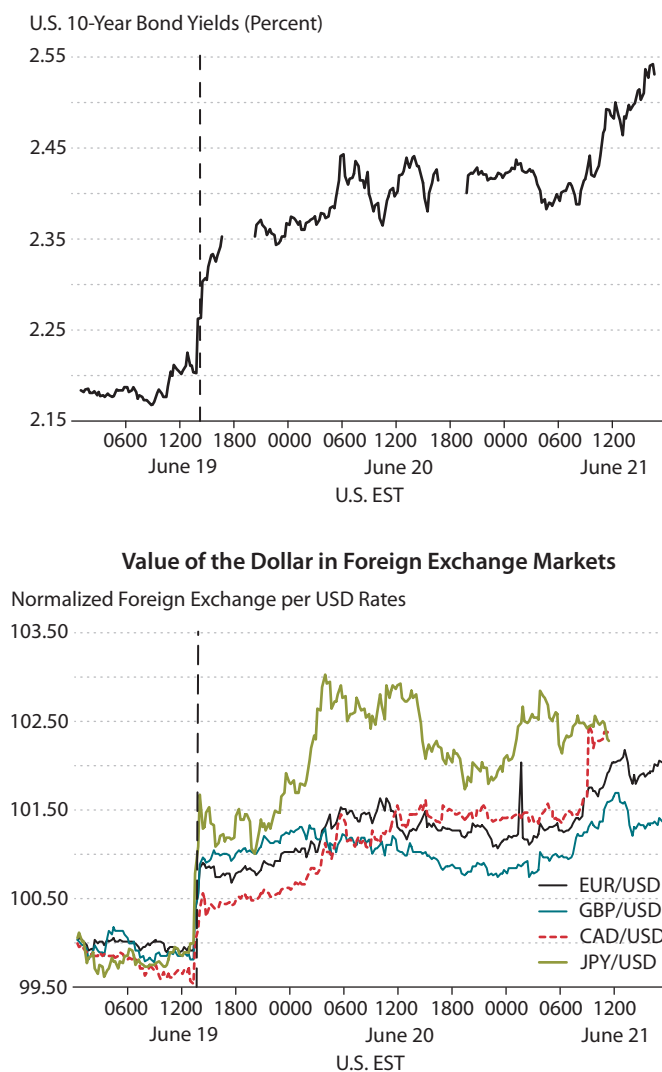
Since November 2008, the Federal Open Market Committee (FOMC) has been using bond purchases to reduce long-term interest rates to support housing markets, employment, and real activity. The FOMC has varied these large-scale asset purchases—commonly called quantitative easing (QE)—with the perceived state of the economy. Its most recent incarnation of QE, QE3, announced in two phases (September 13 and December 12, 2012), committed the Fed to monthly purchases of \$85 billion in bonds.

It is difficult to learn how QE programs affect macroeconomic variables, such as output, employment, and inflation, because other factors—for example, other economic policies, investor expectations, and technologies—also constantly affect these variables. In addition, monetary policies, such as QE, are thought to affect macroeconomic variables with “long and variable lags,” in the words of Milton Friedman (1961). In other words, it is difficult to determine how QE affects macroeconomic variables because economists cannot know for sure how those variables would have behaved in the absence of QE.

Researchers can, however, clearly see how QE announcements immediately affect asset prices, such as bond yields, exchange rates, and equity and commodity prices, because asset prices respond rapidly to new information, such as that in QE announcements. Such asset-price effects are important because most theories of how monetary policy affects the macroeconomy assume that monetary policy shocks affect macroeconomic activity through asset prices. For example, a reduction in the federal funds rate might stimulate consumption or investment by making borrowing cheaper. Understanding the effects of the Fed’s bond purchases on asset prices is an important first step to understanding the broader impact of QE.

Events following a policy announcement last summer afforded researchers an opportunity to confirm previous findings of the effect of such bond purchases on asset prices. First, positive economic news in the spring of 2013 led Federal Reserve Chairman Ben Bernanke to testify to

Asset Prices Around the June 19, 2013, FOMC Meeting and Press Conference



NOTE: The top and bottom panels show U.S. 10-year bond yields and the foreign exchange value of the dollar near the FOMC meeting and press conference of June 19, 2013. The dashed vertical lines denote 2:15 pm EST, on June 19, 2013. CAD, Canadian dollar; EUR, euro; GBP, British pound; JPY, Japanese yen; USD, U.S. dollar. Missing values reflect no reported trading.

Congress on May 22, 2013, that the Fed would likely start slowing—that is, tapering—the pace of its bond purchases later in the year, conditional on continuing good economic news. This testimony laid the groundwork for the June 19 press conference in which the Chairman optimistically described economic conditions and again suggested that asset purchases might be reduced later in 2013: “[T]he Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year.”

The evidence from last summer suggests that QE programs have had the desired effect on asset prices.

The charts illustrate that both the long-term U.S. bond yields and the foreign exchange value of the dollar relative to other major currencies rose substantially at the time of the press conference, as the surprising announcement led markets to expect a reduction in the high level of monetary stimulus. These price movements made borrowing for consumption or fixed investment more expensive and U.S. goods more expensive relative to their foreign counterparts. Several such episodes in the summer of 2013 became collectively known as the “taper tantrum.”

The strong market reactions to the Federal Reserve’s suggestion that it would taper its asset purchases are consistent with the similarly strong reactions—in the opposite direction—to unexpected Federal Reserve asset purchase announcements. The lesson from the taper tantrum is that the QE programs have had the desired effect on asset prices, suggesting that the purchases have influenced output, employment, and inflation expectations in the desired direction. ■

REFERENCES

- Bernanke, Ben. “Transcript of Chairman Bernanke’s Press Conference.” June 19, 2013; <http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20130619.pdf>.
- Friedman, Milton. “The Lag in Effect of Monetary Policy.” *Journal of Political Economy*, October 1961, 69(5), 447-66.