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ECONOMIC TALKING POINTS

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The Fed Speaks: Economic Activity Has "Picked Up."
So Is It Time To Tighten?

Today's FOMC statement is virtually identical to that of August's, except in two respects. It now recognizes that "activity has picked up" as opposed August's description, which saw economy merely "leveling out."

But it's the second change that may be more intriguing because it hints of plans by the Fed to shortly begin sopping up some of the excess money pumped into the economy. The FOMC August statement mentioned that the central bank "will employ ***all*** available tools to promote economic recovery and price stability." The wording was toned down a little this time to read "the Federal Reserve will continue to employ a wide range of tools to promote economic recovery…."

Are we reading too much into these words? Perhaps. But one thing is certain. This statement, along with recent comments by Bernanke, shows that the Fed believes a genuine recovery is now underway and that the next critical stage in terms of monetary policy will be how to gradually remove the extraordinary amount of liquidity injected into the economy the last two years. That process will not be easy. If you think the Federal Reserve had it tough devising a strategy to rescue the US economy from of the worst recession in 70 years, just wait. We think it is going to be hellishly more complicated this time to come up with a plan that encourages growth AND keeps inflation expectations well anchored. What makes it so difficult now are the enormous political and economic pressures bearing down on the Fed these days. Any major

misstep by Bernanke at this point could easily ignite a movement in Congress to restructure the Federal Reserve in a way that could weaken its independence.

Here's the problem in a nutshell. The Fed has pumped more than $800 billon into the banking system, kept the federal funds rate near zero, and purchased so many treasury securities and mortgage-backed debt that the amount of assets on its balance sheets has now swollen to $2.14 trillion. All that stimulus was designed to do two things: Help revive economic activity and restore the banking system to health. There's been progress on both these fronts.

But one uncertainty still looms large for the Fed. Is this recovery really sustainable? Or will the economy slip back in recession in 2010 once the Obama stimulus program has run its course?

Of course, to play safe, the Fed could choose to wait and see if this incipient recovery gathers momentum before taking back some liquidity. That will certainly please the business community, especially those in the interest-sensitive sectors of the economy, such as housing and motor vehicles. That plan would also put a smile on policymakers in the White House and Congress, since the longer all that monetary stimulus remains out there, the quicker jobs will recover.

But this strategy would infuriate U.S. and foreign investors who fear that any delay in monetary tightening by the Fed at a time when US and foreign economies are ramping up could fire up inflation pressures, and that would erode the value of financial assets.

Then there's the other side of the policy option. If the Federal Reserve pursues a more aggressive tightening policy now to keep inflation expectations well anchored, it may come at a devastating political cost. For one, any tightening move by the Fed at this delicate stage in the recovery would invite the wrath of the business community, which may choose to postpone adding workers. Second, the Fed will likely face vitriolic condemnation from Congress. Just imagine the fury: "How dare Bernanke and his minions at the Fed step on the brakes now with the unemployment rate still above 9%. We need more supervision of those guys. Let's get some auditors in there. Let's change the way it chooses who sits on the FOMC and votes on interest rate policy."

Clearly, any move by the Fed to withdraw credit or raise interest rates at this juncture is fraught with political risk and may lead to institutional changes at the central bank.

At the risk of stating the obvious, the Federal Reserve looks to be in a real bind. But is there a way out of this dilemma? There is --- and it lies in the subtleties of future FOMC statements and actions. Let's take it step by step.

(1) The Fed has expressed its belief that the recovery has begun.

(2) If history is any guide, the risk of a relapse back to recession is extremely small. Without exception, every steep economic downturn in the last century was followed by a

vigorous recovery. Thus, the odds this recovery will peter out the next two years are very slim. Still, it can't be ruled out since each recession is triggered by different circumstances.

(3) That leaves us with concerns about future inflation. Many will argue there is just way too much labor and industrial slack in the economy for inflation to be problematic the next few years. The latest FOMC statement alluded to this. "With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain subdued for some time." This is certainly a reasonable argument. But let's not forget that back in the 1970s we also had lots of slack in the labor market --- and that did not prevent inflation from shooting up. So we can't completely dismiss the threat of inflation the next two years, especially if a synchronous global economic recovery is in the works.

(4) Now that the recovery has commenced, with housing, industrial production and consumer spending all picking up speed, the Fed really has little choice but to begin the process of withdrawing liquidity in the coming weeks. The question is how to do it without getting into a firefight with Congress and the White House? In terms of actions, we suspect the Fed will pursue two strategies in the short run. The first is in its rhetoric. In speeches and testimony the Fed will hammer the point home again and again on the importance of firmly controlling inflation. No recovery can last without price stability. The analogy would be similar to containing a forest fire. The sooner you act to douse it, the fewer resources will be spent and the less damage the fire causes. Wait too long, however, and both the cost and devastation will be much greater. So the Fed will need to justify why preemption is so important.

Beyond the rhetoric, we believe the Fed will gradually and selectively begin to remove some monetary stimulus in the coming weeks. The one action we do not expect to see until late next year is the most politically sensitive of all --- raising the fed funds rate. That won't start until payrolls are solidly growing again. Once we see several months of real job growth, the Fed will be able to lift rates without the shadow of Congress hovering angrily overhead. Our forecast is for the Fed to begin lifting rates mid 2010, to 0.5%, and to 1% by the end of 2010.

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