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ECONOMIC TALKING POINTS

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Flash Note:
The Fed Stands Pat Even Though Its Latest Projections Worsen

The Federal Reserve punted on any decision to act until their next meeting in late January. Why choose not to act now? We suspect it's for three reasons.

First, the Fed probably wanted to preserve its ammo until there is more clarity on how the European sovereign debt crisis unfolds in the weeks ahead. The Eurozone bailout plan announced last week had a calming effect on the markets and reduced the chance of a financial meltdown. Then came yesterday's stunning news by Greek PM Papandreou, who called for a national referendum on the entire rescue package and the austerity measures the country must take. The referendum will likely not take place before December. But given the large social unrest in Greece nowadays, it leaves open the question as to how the public will ultimately vote. If they give it a thumbs down, it would likely lead to a disorderly default by Greece, force a pay out on credit default swaps, risk seeing the Eurozone fall apart, and trigger a European banking crisis that could easily spill into the US. This is high stakes international finance!

The Fed probably thought it best to hold off until the dust settles in Europe, or perversely, if the Eurozone looks like its going up in smoke.

The second reason is that recent indicators show the US economy experiencing some cross currents. While housing and employment remains depressed, there was positive good news to acknowledge: third quarter GDP "strengthened somewhat," consumer spending "increased at a somewhat faster pace," and business capital spending "has continued to expand." Thus, pressure on the Federal Reserve to announce a QE3 plan had eased.

The third reason is pure speculation on my part, but I suspect the Fed would much prefer to announce major policy changes on those FOMC meetings that are not immediately followed by a press conference. True, this may represent a cynical view of how the Fed chooses to operate in times of great turmoil, but I leave it out there as one possible consideration.

Clearly the most surprising part of the statement is the 180-degree turnaround on the Committee vote. Where as the last two FOMC meetings had three dissenters (Fisher, Plosser, and Korcherlakota) criticize the Fed for being too accommodative, this time there was only one who dissented, FRB President Charles Evans, and he was upset there wasn't additional monetary easing.

Should the Fed have done more at this meeting? Yes. At the very least they could have slashed or eliminated the 25 basis point interest paid to banks on excess reserves. That would have sent a clear signal to lenders that they need to ramp up loans to individuals and small businesses.

Furthermore, the Fed should have moved more aggressively to buy mortgage-backed securities in an effort to add liquidity to the secondary mortgage market and bring down rates on conventional mortgages to below 4%. As we have seen in every previous recovery cycle, a revived housing market will generate more economic growth, rebuild household wealth, accelerate consumer spending, and increase employment.

Instead, the Fed chose to wait until 2012 to act, despite a dismal growth rate so far this year of less than 2% and unemployment chronically above 9%. Worse still, in their latest projections of the US economy, the Fed has

ratcheted down expectations for growth in 2012 by nearly a full percentage point compared to its June forecasts, and some 50 to 70 basis points less in 2013. Moreover, unemployment is now forecast to remain higher the next two years, hovering above 8%.

It's a grim assessment of the future and this makes it all the more surprising that Charles Evans was all alone in calling for more monetary easing.

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