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ECONOMIC TALKING POINTS

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September 20, 2011

What's Next From the Fed…and Will Anything Work?

There is a growing consensus that the Federal Reserve could announce plans tomorrow to begin Operation Twist, which will involve selling short term Treasuries and use the proceeds of maturing securities to buy longer-term government debt and drive those yields down even more.

They may also choose to reduce or eliminate the 25 basis point interest rate the Fed pays on reserves banks hold in the Federal Reserve System. Any one of these steps will generate lots of talk in the investment community.

In the final analysis, however, we believe neither will do very much to accelerate economic activity.

For one, interest rates across the entire Treasury maturity spectrum have already plummeted to at or near record lows. Pushing down the cost of credit another 10 to 20 basis points is hardly going to win over consumers, investors or business leaders, all of whom are beset with concerns about the economic outlook and exasperated by the political gridlock in Washington.

Secondly, firms are already flush with cash. Last week the Fed released its *Flow of Funds* report for the second quarter and it showed that U.S. companies are swamped in cash, with a record $2 trillion waiting to be deployed for productive use. Yet they sit idle, and that raises the question why firms should borrow ---even with record low rates --- when cash balances are so high AND with an economic outlook that looks so grim?

Just look at the latest IMF report on the world economy. The international organization has slashed forecasts for virtually every country on the planet, even warning the US and Europe could slip into recession in 2012. The IMF hacked away its forecast of US GDP growth this year from 2.5% (made just three months ago) to a meager 1.5%. Conditions are not going to get much better in 2012, since they shaved next year's forecast nearly in half, from 2.7% to 1.8%. Their projections for Japan, Europe and the emerging countries were also lowered. This is hardly the kind of climate that encourages business leaders to confidently to borrow fresh funds.

The Fed also knows it is the consumer that ultimately will have to rescue the economy. Yet Americans continue to eschew debt. The latest *Flow of Funds* show that household debt fell at a rate of 0.6% in the second quarter, which means there has been absolutely no let up in the deleveraging process that began the summer of 2008. So what are left with? Well, with job creation so pathetic and wages failing to keep up with inflation, does anyone really think consumers will feel the urge to rush out and borrow just because rates slipped a few more basis points? I doubt it.

Fourth, when President Obama yesterday presented his deficit reduction plan yesterday, it underscored the massive ideological divide between himself and Republicans. There may well be an unbridgeable gap between the two, which means little is likely to get done in Washington until after the next Presidential election.

Let's put it all together and see what the Fed is up against.

With Washington utterly dysfunctional, the US economy still teetering close to recession, corporate earnings expected to weaken, a sovereign debt default looming in Europe, fresh geopolitical risks spreading across the Middle East (and their implications for future oil prices), it is hard to conclude that lowering the cost of long term money by a few basis points will change anything.

So what is the Fed trying to achieve with Operation Twist? Perhaps three things.

It wants to demonstrate that it is still a relevant force, capable of influencing economic activity despite the political paralysis over fiscal policy. After all, imagine how the financial markets would react if Fed officials explicitly admitted how impotent monetary policy is at this stage. The spotlight is on the Fed simply because outside of monetary policy, there is no other policy initiative coming from Washington. The Fed is the only game in town!

The second Fed goal is to drive rates so low that it encourages investors to seek out higher returns, perhaps by purchasing more equities. After all, higher stock values lifts household wealth and that "*hopefully*" will foster more consumer spending. Lower yields on Treasuries will also drive down the cost of capital and "*hopefully*" spur business investments and set the stage for more hiring as well.

There may also another far more controversial strategy in play here. We are beginning to suspect that the move to lower yields is an implicit move by doves on the Fed to have their full employment mandate supercede --- this one time--- the goal of targeting inflation at around 2%. In other words, allow inflation to climb above 4% or 5% if it can bring down unemployment to 8% or less. Of course, you won't see any such reference in an FOMC statement. But hints of this strategy could emerge in the coming months from speeches by members of the FOMC. To be sure, even a higher inflation target is an extremely risky strategy at a time when Americans are still working to pare down debt and with real wages eroding.

Bottom line:

If you stand back for a moment, it is the efficacy of monetary policy that is really at risk here. The Fed is under pressure to dig deeper than ever into its bag of tools to see what works. Our feeling is the most they can accomplish is prevent an economic contraction. Without some cooperation from Congress and the White House on the fiscal side, the Fed may have no choice but to settle for that minimal achievement.

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