

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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Is it smart monetary policy --- or a crapshoot?

The Fed's decision to sell \$400 billion worth of Treasuries that mature in 3 years or less, and use the proceeds to purchase Treasuries with maturities in the 6 to 30-year range will certainly spark much debate in coming weeks.

Ultimately, today's announcement will have no meaningful impact on growth. It will not accelerate GDP into the 3% range, nor will it spur job creation. What is weighing the economy down is **NOT** the high cost of credit. Rates across the entire maturity spectrum are already the lowest in modern history.

Indeed, the Fed's latest action is really little more than a distraction from the many other factors that **are** depressing growth, namely poor loan demand, households that are still deleveraging, the embarrassing political stalemate in Washington over fiscal policy, worries that a European sovereign debt default is imminent with damage that could spill into the US, and a host of geopolitical hot spots that threaten to lift oil prices again.

If we were to pick the issue that stands out most at the moment, it is the failure of governing in Washington at a time when so many Americans are hurting. The political food fight between the White House and Republicans

will certainly not hasten economic growth nor create a single private sector job. Indeed, there is a real fear that the gap between the two sides is unbridgeable, which means we may not see any changes in fiscal policy until after the 2012 presidential elections.

The lack of clarity on the economic outlook has thus put consumer spending on hold, slowed business investments, and halted new hiring.

Still, the Fed feels it has to demonstrate it remains relevant in this business cycle and that it can buck political pressures from the GOP, which explicitly urged the central bank to do nothing.

Will today's action help at all?

Well, yes, it will reduce debt service for Americans who carry medium and longer term loans. It might even push down rates on 30-year mortgages to an incredible 3% handle, which could revive a pulse rate in the comatose residential real estate market.

But today's move could also backfire. It may make it less profitable for banks to lend. After all, the sale of short term securities will likely raise the cost of acquiring funds for lending institutions, but reduce the rate they can charge on loans. The narrowing of net interest margins might encourage banks to simply keep reserves sitting with the Fed, where they at least get 25 basis points, a return incidentally that is greater than investing in 2 Yr. Treasuries!

So we do not see how today's actions will incentivize banks to open the lending window wider. If anything, financial institutions are still working on cleaning up their balance sheets and beefing up capital.

One other perception is that the Fed is now experimenting with actions so far outside its normal playbook, it is taking on the appearance of a crap shoot. The bet? If you keep pounding down medium and long term rates enough, this will --- at some point! ---**have** to ignite growth. Perhaps so, but it is a dangerous gamble. If it doesn't work, it will depict in the starkest possible way just how impotent monetary policy has become in this economy.

Perhaps, the most baffling phase in the Fed's statement is how inflation "appears to have moderated since earlier in the year." That observation departs from reality. The latest cost of living data shows inflation has accelerated. Consumer prices, for example, both headline and core, are now at their highest level in three years on an annual basis. In fact, it has

been rising virtually every month since November 2010, while economic growth the first half of the year has slowed to less than 1%.

Lurking ahead therefore is not price stability, but stagflation. For the Fed to downplay inflation pressures is just another concern we have of the central bank's latest strategy.

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