THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

September 13, 2012

So much monetary buzz, so little consequence

Just a brief note before the Federal Reserve makes public its decision on QE 3.

Here's the key question. Realistically, what impact will additional Fed easing have on the economy? Recent history shouts the answer.

The Fed began to cut short-term interest rates in September 2007, from 5.25% to virtually zero by December 2008!

It didn't stop there. In an unprecedented set of actions, it also bought more than $2 trillion in treasuries and mortgage-backed securities, which pushed longer term rates down to their lowest ever too. Moreover, the Fed has been running another program, Operation Twist, to replace $400 billion of short-term debt with longer-term securities. All told, they have pumped liquidity into the economy on a scale never seen before. Never before has the cost of credit been so cheap.

So how has the economy responded? Average annual real GDP growth in the last four full years (2008 – 2011) was…..0.2% a year!! That's it! As of the second quarter of this year, the size of the US economy is just 2.2% larger than it was in 2008! The unemployment rate has remained stuck above 8% for more than 40 straight months!

There is no more vivid illustration of the current limitations of monetary policy. Investors and business leaders face a paralytic Congress and a gallimaufry of downside fiscal and geopolitical risks. Try as it might, the Fed cannot prompt the economy to do much more under these circumstances.

Simply put, the US economy has *not* failed to grow because there is a lack of liquidity. It has *not* failed to grow because the cost of credit is too high. The economy has more liquidity than ever before and interest rates have never been lower. So what *is* holding up business activity and employment?

To slightly modify a phrase from the Clinton era: “It’s the political economy, stupid” that has held the real economy hostage.