

The New York Times

December 17, 2010

Keeping the Good News in Perspective

By DAVID LEONHARDT

The most recent batch of economic data has been quite positive. On Thursday alone, three different reports showed that initial jobless claims had fallen, housing starts and the issuance of building permits had both risen and a Federal Reserve index of manufacturing activity rose too.

But before getting too excited about these trends, let's think back to the early part of this year. Back then, initial jobless claims were falling. Housing starts and the issuance of building permits were rising. A Federal Reserve index of manufacturing activity was rising too.

And then what happened? The recovery stopped. Some people blame the debt crisis in Europe (which, of course, has not ended). Others think we'll never know exactly what stopped the recovery, because the aftermath of a financial crisis tends to be difficult.

That last point is important. Yes, the latest data has been good. But the economy remains both weak and vulnerable. The notion that a couple of weeks of decent news should cause the Fed to proclaim victory and halt its campaign to lift growth — a notion you're starting to hear — seems misplaced.

Here's the thoughtful **Bernard Baumohl**, chief global economist of the Economic Outlook Group, in a note to clients:

“Clearly, the economy continues to move in the right direction. What troubles me is that the Federal Reserve doesn't fully realize the nuanced relationship it has with the bond

market as this critical stage in the recovery....

[I]f the declarative goal of the Fed is to use the \$600 billion in QE2 simply to lower the unemployment rate even as an economic recovery is underway, then it risks agitating the bond market who fear the central bank may overshoot by adding yet more money when the financial system is already flooded with excess reserves. Such anxieties will drive market rates higher, raise the cost of capital, and ultimately undermine the Fed's own goals."

These are legitimate concerns. As Mr. Baumohl suggests, the Fed needs to make sure that bond investors know it stands ready to withdraw its support for the economy — and let interest rates rise — as soon as the recovery seems assured. Otherwise, the bond market will get spooked about inflation and send long-term rates up on its own, thereby putting the recovery at risk.

But there are no free lunches here. If the Fed immediately halted its efforts to lift growth (like the bond-buying program known as QE2), the recovery might die out, just as it did earlier this year. The Fed's job here is to judge the relative risk of various problems. So far, the bond markets show little sign of being agitated. Read Martin Wolf, Mark Thoma or Jeremy Siegel for more on this point: the recent rise in rates isn't really about inflation worries.

On the other hand, the recovery remains nascent and vulnerable. Any number of factors — Ireland, Spain, a post-holiday consumer pullback in the United States — could cause problems. Given all this, the Fed would seem to be taking a bigger risk by ending QE2 than by continuing.

Put it this way: When the last monthly jobs report showed a gain of only 39,000 jobs, far less than needed to keep up with population growth, economic weakness still appears to be the main reason for concern.