Post-QE2 plans the focus of Bernanke conference

By Greg Robb, MarketWatch

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WASHINGTON (MarketWatch) — For good reason, Federal Reserve Chairman Ben Bernanke has been studying videotapes of foreign central bankers and having staffers pepper him with questions ahead of his first-ever press conference Wednesday to discuss an interest rate decision.

Not that the central bank is sweating whether to veer from its current policy of targeting a Fed funds rate between 0% and 0.25% and its plan to purchase $600 billion worth of government debt by the end of June. The Federal Open Market Committee will announce its decision in a statement on 12:30 p.m., followed by a Bernanke press conference due to start at 2:15 p.m. Eastern.

“It is still too early to move,” said John Silvia, chief economist at Wells Fargo. “There are too many questions about the outlook, combined with deficit craziness in Washington. There is no logic for the Fed to do anything except repeat everything they have said,” Silvia added.

The question is what to do after the current bond purchase program ends.

The Fed has kept its target federal funds rate between zero and 0.25% since December 2008, and markets don’t have a rate hike priced in until the end of the first quarter of 2012, as hawkish talk from regional

presidents, such as Philadelphia Fed President Charles Plosser, has been outweighed by cooler economic data.

Still, Fed watchers are divided on whether the central bank will signal what it plans to do with the size of its balance sheet once the program known informally as QE2 ends in June.

The central bank has expanded its balance sheet to a record $2.65 trillion from $870 billion in December 2007.

Many think the Fed will not send any signals at this meeting so they can remain flexible.

But others, including Michael Gapen at Barclays Capital, believe the Fed needs to talk before the June FOMC meeting so as not to run the risk of unsettling markets.

The decision is a potential flash point as hawks will want to get started on shrinking the balance sheet by letting maturing securities roll off. The doves will argue against the move that they would view as passive tightening. They will want to freeze the size of the Fed's balance sheet by replacing maturing mortgage debt with Treasurys.

Mizuho Securities U.S. chief economist Steve Ricchiuto expects no decision on the issue at the April meeting. He said Bernanke is going to be very deliberate about exiting from the ultra-low monetary policy.

Last spring, the economy screeched to a halt in the April-June quarter after a robust beginning of the year. Ricchiuto attributes the slowdown in growth to the ending of the Fed's first asset-buying program.

"Last time we removed quantitative easing, the economy stumbled, " Ricchiuto said

Little is known for certain about how the Fed should exit, Ricchiuto said.

"Only one other country, Japan, has done it, and it backfired," he said.

After the last FOMC meeting in mid-March, economists were looking forward to the April 26-27 meeting, thinking it was going to contain fireworks and some clarity about the Fed's exit strategy.

But these expectations have deflated along with growth estimates for the first quarter.

The wheels seemed to come off the economy in the first quarter, analysts now believe, with growth sputtering below a 2% rate following a 3.1% growth rate in the fourth quarter. Data on first-quarter GDP is due just a day later.

“The risk of a growth recession is increasing, especially in the second half of the year,” said **Bernard Baumohl,** chief global economist at the Economic Outlook Group.

“The economy has decelerated to the point where companies may grow reluctant to hire more workers,” he added.

Only a few months ago, economists were confident growth would accelerate to a 4% rate in the first quarter and the economy was on a “self-sustaining” path that would slowly and steadily bring down the unemployment rate.

Even the Fed got excited, saying after its March 15 meeting that the economy was on “firmer footing.”

Still, many economists maintain the view that growth will accelerate as the year progresses, particularly if the spike in oil unwinds. They point to a resurgent manufacturing sector and a slowly improving labor market that’s putting more people back to work — and putting more cash into the economy.

But Ricchiuto scoffs at the notion.

“Everyone was expecting 4% growth but now they are expecting 1.4% growth. But they think the economy will get stronger? How do I know they have anything right.” he asked.

Although there is concern about inflation, the Fed got two pieces of good news that will allow them to remain on the sideline at next week’s meeting. Core consumer prices, excluding food and energy, rose only 0.1% in March. And consumer’s long-term inflation expectations, as measured by Thomson Reuters and the University of Michigan, retreated in early April.

Another reason for caution from the Fed is the push in Washington for a budget deal.

These efforts may have received a boost when Standard and Poor's cut its rating outlook on the U.S. to negative from stable.

Even if Washington does nothing, government spending will shrink.

White House projections see the deficit falling from $1.1 trillion in this fiscal year to $750 billion in fiscal 2013, the biggest two-year drop in American history, said Stan Collender, a partner in Qorvis Communications LLC.

"Fed officials don't want to risk double dip by raising rates when the government is tightening fiscal policy," added Victor Li, an economics professor at Villanova School of Business, who worked with Bernanke at Princeton,

Looking at the future course of policy, at the moment, economists expect the Fed to take baby steps toward the exit over the rest of 2011.

The overwhelming majority see little chance of another round of asset purchases.

Only a few economists, including former Obama administration economist Christina Romer, have argued in favor of a QE3.

Silvia of Wells Fargo said the Fed will hold steady until August and then start to draft an exit plan.

"By August, they'll have an idea whether growth is sustainable or not," Silvia said.