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Fed Makes No Mention of Japan

Federal Reserve policy statements are supposed to outline the forces that will drive monetary policy over coming months, so while it wasn't unexpected, it's nevertheless puzzling central bankers omitted the biggest risk of all: Japan.

It is true economists are still trying to come to terms with the fluid and very unpredictable course of events coming out of Japan in the wake of last week's earthquake and tsunami, which has turned into a humanitarian catastrophe and metastasizing nuclear disaster. No forecasters can say with any reliability what impact Japan will have on the world economy, or on the U.S. economy.

And yet, for a Fed that likes to weigh all the risks to the outlook, one of the biggest ones out there is the impact Japan might have on the U.S. Economists have flagged the automotive and technology sectors as potential problem spots, but Japan's tragedy has the potential to go further and strike at financial markets. That could have knock-on effects on the growth outlook and how the Fed pursues monetary policy.

As it stands now, Fed policy makers see a recovery standing on "firmer footing" amid labor markets that are "improving gradually." While it expects inflation to remain contained, it nevertheless notes rising commodity and energy prices are "putting upward pressure" on inflation, even as policy makers see the gains as "transitory." Most Fed watchers had anticipated the Fed would say that, as much as they also saw the central bank continuing forward with its $600 billion bond-buying program.

Fed watchers looked to what the central bank said and saw it as evidence the Fed is growing more confident in the recovery. "Our expectation for a mid-2012 rate hike is not changed by this statement" and "it does point to the Fed beginning the baby steps required to exit from its current strategy," said **Eric Green** of **TD Securities**.

And yet, Japan has the potential to change this outlook, in very significant ways. For one, the powerful downdraft swamping global markets is a problem for the Fed. If stock prices fall significantly, the Fed may have to react by providing more economic stimulus. Central bank officials have pointed to the rise in equity prices since embarking on QE2 as a signature success of the policy. If stocks were to fall a lot, the impact on confidence and wealth would have to be taken into account by policy makers, given the central role officials like Fed Chairman **Ben Bernanke** have granted markets.

More broadly, if supply-chain disruptions proved truly profound and wounded the auto and technology industries, they could blunt or end the powerful round of growth seen over recent months. Factories, even at their relatively small share of U.S. output, have been a major engine of the recovery, so weakness there would be worrisome for the broader course of the move out of recession.

Continued Japan problems could change the Fed outlook in other ways. Fed officials Tuesday flagged their awareness of the impact energy was having on pushing up inflation. But oil prices have fallen as Japan's problems have grown. Perhaps, demand for oil will now be weaker and reduce the brewing inflation problem central bankers acknowledge.

None of this is to say there's been a big shift in the odds the Fed will continue QE2 beyond its currently stated target. But as much as anything mentioned in the Fed statement, the unacknowledged problems in Japan could be a big influence on monetary-policy decisions over coming months. Said **RBS Securities** analysts: "The uncertainty generated by recent developments in Japan gives the Fed even more reason to show patience. Indeed, it is possible lingering uncertainty could push back the timetable for Fed action."

Economists are currently split over the impact Japan might have on the U.S. **Deutsche Bank** economists said in a research note “the possible effects on the U.S. economy from the earthquake in Japan appear less damaging than the recent weakness in U.S. markets would imply.”

But not everyone agrees with that view. Japanese events, along with political unrest in the Middle East, are a potential game changer, warns **Bernard Baumohl** of the **Economic Outlook Group**. “The first two weeks of March unleashed a fusillade of geopolitical and natural shocks the likes of which we haven’t seen since World War II,” he said, noting “the shocks will ripple through the world economy for years to come.”