MarketWatch

The Fed

Fed must be flexible given oil prices, Lockhart says

Dallas Fed chief says prices could go even higher

By Greg Robb

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WASHINGTON (MarketWatch) — The Federal Reserve may want to consider a third round of bond purchases if an oil shock materializes, a central bank official said Monday.

Dennis Lockhart, the president of the Atlanta Fed, said that while his first instinct is to be “very cautious” about making another round of bond purchases once the Fed’s $600 billion bond-buy program expires in June, he said he would consider them depending on oil prices.

Given the new risks from the Middle East turmoil, “I prefer a posture of flexibility as regards to policy options,” he said in a speech at the National Association for Business Economics.

Lockhart doesn’t actually have a vote on the matter until next year, though he does participate in Federal Open Market Committee meetings.

Noting that economic studies show a high correlation between oil shocks and the onset of recessions, Lockhart said it was possible that prices may rise to a level that would endanger the economic recovery and force the Fed to ease further with another round of asset purchases. Read MarketWatch First Take ‘Fed should ease in oil shock.’

Former IMF chief economist Michael Mussa said the Fed should “sit tight” and not feel the need to respond to the oil prices rise.

“There is a limited amount monetary policy can do,” Mussa said in an interview.

In light of the oil-price increase to date, Mussa said he might trim his U.S. GDP forecast by half a percentage point, leaving it around a 3.3% rate.

Lockhart said he was not ruling out his “base case” of a sustained recovery of growth in 2001 around the 3% to 4% range, with inflation firming to a trend rate around 2%, and with gradual employment growth.

A moderate increase in oil prices for a short or intermediate period of time is “manageable” for the economy, Lockhart said.

The Atlanta Fed president said he did not think that businesses are going to be able to pass along higher oil prices to customers.

“My sense is there is still concern that demand is fragile and pricing power too limited for most markets to take extensive price increases,” Lockhart said.

The Fed’s most recent Beige Book survey of economic conditions released last week found that some firms had succeeded in raising prices.

Although many believe that the rising oil prices are just “chapter one” of a surge in consumer price inflation, Lockhart said he did not expect this to happen.

One missing ingredient for higher inflation is upward wage pressures, he noted.

“I do not see widespread wage pressures developing any time soon in the current circumstances of upwards of 20 million people either out of work or working part-time for economic reasons,” Lockhart said.

While core inflation has firmed, so far the increase “is not undesired,” Lockhart said, as it moves inflation closer to the Fed’s informal target near a 2% growth rate.

Lockhart said he was more confident about the economy than he was at the beginning of last year.

In an interview at the NABE event, **Bernard Baumohl,** managing director of The Economic Outlook Group, said he now expects the economy to slow markedly this year but not enough to “extinguish” the recovery.

“There is a dark cloud hovering over the U.S. and international economy” from the geopolitical events in the Middle East, **Baumohl** said.

Economists have a tough time forecasting “what is going to happen around the corner” because the events in the Middle East do not fit neatly into economic models, Baumohl said.

The upheaval could last a generation, he said.

Fisher wary

In a separate speech on Monday, Dallas Federal Reserve Bank President Richard Fisher became the first top Fed official to say he may vote to curtail the central bank’s $600 billion bond program.

“If at any time between now and June, it should prove demonstrably counterproductive, I will vote to curtail or perhaps discontinue it,” Fisher said in a speech to an international bankers’ trade group.

Fisher has previously said he was opposed to the program but only became a voting FOMC member in January.

Fisher said the liquidity tanks of the economy are full “if not brimming over.”

Further Fed accommodation may hamper job creation and cause investors to begin to anticipate an increase in inflation. The recovery is “well under way,” Fisher said.