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Fed Action Likely, But Results Not

By Danielle Kurtzleben
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In attempting to deal with an impossibly complex economic crisis, the Federal Reserve may end up illustrating the simple economic principle of diminishing returns.

Economic pressures are increasing: persistent high unemployment and increasing inflation make it appear increasingly likely that the Fed, whose dual mandate is to keep unemployment low and prices stable, will take action soon. The Fed is also taking more time to consider its options this month, with the Federal Open Market Committee meeting for two days, extended from the originally planned one day, "to allow a fuller discussion" of tools at the Fed's disposal, in the words of Fed Chair Ben Bernanke. But even with both the increased pressure and time, the Fed's capacity to manufacture effective relief from the economic downturn appears smaller than ever.

"I think they've run out of levers to pull," says Bob Andres, chief investment officer and strategist at Merion Wealth Partners. "There can be levers that have some kind of possible psychological impact, but I don't think they have any significant tools left to do anything to juice the economy."

Since the nation's economic troubles began in 2008, the Fed has attempted several stimulative measures: two rounds of massive asset purchases, known as quantitative easing; maintenance of near-zero interest rates; and the dramatic announcement in August that it would keep those interest rates low through mid-2013. Now, there are only a few options left for the Fed, all of which either look unlikely to be stimulative, unlikely to pass the divided committee, or both.

One of the most talked-about options in advance of this week's meeting has been the so-called "Operation Twist," a program of selling short-term bonds and purchasing long-term bonds. Antulio Bomfim, senior managing director at economic consulting firm Macroeconomic Advisers, believes that any decision on such a program would likely come in November, after more Open Market Committee discussion of the specifics of selling and buying. Far more likely at this week's meeting, says Bomfim, is what he calls "Operation Twist Lite." In this program, the Fed every month simply replaces matured treasuries on its balance sheet with longer-term securities in the hope of lowering longer-term borrowing rates.

Another option is to lower the interest rate paid to banks on their reserves, in the hopes of stimulating banks to sit on less cash. **Bernard Baumohl,** chief global economist with consulting firm The Economic Outlook Group, believes that "neither [Operation Twist or a lower reserve rate] will do very much to accelerate economic activity," as he wrote in a commentary today. He notes that pushing down the cost of credit and encouraging borrowing are ineffective tactics when interest rates are already low across the board for treasuries and many firms are sitting on cash.

Last but by no means least is a third round of quantitative easing, which appears unlikely, as inflation has risen considerably since QE2. According to the Bureau of Labor Statistics, in November 2010, when that program was instituted, the annual percent change in the core consumer price index was 0.8 percent. As of August 2011, it was 2.0 percent. As QE3 would inject yet more cash into the system, that could drive inflation even higher.

Further impeding any policy decisions might be discord within the committee. In August, three members voted against the decision to pledge low interest rates through 2013?, saying they would prefer to say that the rate would be low for an "extended period." Though one of those dissenters, Minneapolis Fed President Narayana Kocherlakota, has since stated that the Fed should not undo this pledge, the disagreement highlights the ideological rifts within the committee.

The broader lesson seems to be that for all its power, the Fed is powerless to stop the economy from potentially teetering into a double-dip recession. "Monetary policy in any form is not going to get us where we want to go at this point," says Andres. "What has to happen has to be fiscal policy--and time--to get us out of this thing." Given the broad philosophical gulfs separating many congressional Republicans from the president on economic policy, a fiscal solution seems nearly impossible at this point.