What the Fed Do We Do Now?

By: Kathryn Buschman Vasel **June 7, 2012**

It doesn't look good. The unemployment rate ticked up to 8.2% last month, home prices remain stagnant, economic growth was revised down to 1.9% in the first quarter and Europe's fiscal crisis continues to worsen.

So what's the Fed to do?

In his testimony to Congress on Thursday, Federal Reserve Chairman Ben Bernanke did not overtly mention any new plans to boost the economy via so-called quantitative easing, but he did say the central bank was ready to act if the situation worsens, and that the European crisis poses a domestic challenge.

"The situation in Europe poses significant risks to the U.S. financial system and economy and must be monitored closely," Bernanke said to the Joint Economic Committee. "As always, the Federal Reserve remains prepared to take action as needed to protect the U.S. financial system and economy in the event that financial stresses escalate."

He said that he and fellow Fed members "are still working" on whether they will unveil new policy measures at their next meeting, and that they have a number of different options to help boost the recovery. But after multiple rounds of quantitative easing, operation Twist and prolonged rock-bottom interest rates, investors could be wary of any more aid.

"It is going to come down to U.S. growth and jobs numbers that will ultimately decide whether the Fed does QE3 or any other type of policy," says Tim Yeager, former analyst at the Federal Reserve Bank of St. Louis and current associate professor of finance at the University of Arkansas.

While no new policy is expected to come from the Fed's next meeting June 19-20, the vice chairwoman of the Federal Reserve's board of governors said in a speech Wednesday night that the economy remains vulnerable to setbacks.

"It may well be appropriate to insure against adverse shocks that could push the economy into territory where a self-reinforcing downward spiral of economic weakness would be difficult to arrest," said Janet Yellen. She also stated the Fed should consider policies to keep interest rates near historic lows "for quite some time" to help bolster the recovery.

Talk of more Fed action was negligible this time last week, but May's employment report showing significant deterioration to the labor market and job growth rocked the markets on Friday. Now, whispers have started about what action the central bank might take.

If the Fed moves too soon with any policy, Roberts warns it will lead to more Wall Street volatility.

"The Fed is trying to engineer a trading range and any policy might trigger a huge rally and at that point people start leveraging up and make the situation worse."

Doug Roberts, chief investment strategist for Channel Capital Research, points out that while the Fed could buy more Treasury or agency bonds to help induce a stronger recovery, it's Congress that really holds the power to maintain growth.

"The Fed can only stabilize the patient, which in this case is the economy," he said. "It can administer medication and narcotics, but it can't do the necessary surgery to fix the problem long term. Right now, we've been relying too much on drugs. We need something more effective."

Roberts notes that the Fed hasn't begun to print money and still has many options to choose from despite saying it was out of tools in 2007.

Bob McTeer, former president at the Federal Reserve Bank of Dallas and current distinguished fellow at the National Center for Policy Analysis, says the Fed should stop all of its programs and wait to see what happens while keeping a close eye on the balance sheet and total assets to make sure they don't shrink.

"I don't think they have used up all arrows in quiver, they've used up all the interest rates arrows, but they have more monetary policy they can use," he said.

If the Fed does decide to unleash new policy, McTeer suggests not giving it a "big, hairy label."

"People didn't get upset about monetary policy until they started calling it QE1. It became different in scale with the label and when they announced it in advance -- but this is just old-fashioned market operations."

He says the central bank's main goal should be keeping money growing at a moderate and positive pace.

"We don't want to see it shrinking. They should continue to watch the monetary supply and watch the size of the balance sheet and make adjustments as necessary."

Fed vs. Lawmakers

Bernanke also warned lawmakers that “a severe tightening of fiscal policy at the beginning of next year that is built into current law -- the so-called fiscal cliff -- would, if allowed to occur, pose a significant threat to the recovery.”

McTeer says any new or expanded programs or policies from the Fed would take lawmakers “off the hook” for dealing with the nation’s deficit.

“We are looking off a fiscal cliff, we know something has to be done, and if the Fed comes to the rescue, it gives Congress the idea they don’t have to do anything.”

He adds that this might be what the European Central Bank is doing with the eurozone crisis. Despite the bloc’s deepening financial crisis and increased worries that Spain’s banks might need a bailout, the 23-member ECB held interest rates steady at 1% on Wednesday and didn’t hint at any stimulus.

Yeager says the central bank pays very little attention to the ECB moves.

“The ECB has always been conservative and will continue to be that way. If the U.S. was going through the type of crisis they are doing through overseas, the Fed would have been far more aggressive, the Fed isn’t looking at the ECB to be any kind of leader or to get out in front of a crisis.”

He adds that Europe’s turmoil could hurt the U.S. economy because collectively it’s our biggest export market.

“If they slow down and continue to slow down that will hurt our exports,” he says. “The effect won’t be huge, but it will knock a little off our GDP growth, which isn’t strong to start with right now.”

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