Forbes

The FOMC's Options

By: Bob McTeer **June 19, 2012**

When I was on the FOMC (1991-2004), I arrived at the meetings with "soft conclusions" formed. By that I meant I went in with my preferences, but with a mind open enough to be persuaded otherwise. Tonight, my conclusions are softer than usual, but here is the context of tomorrow's FOMC decision as I see it.

The State of the Economy

The economy, never strong, has weakened further. The last two headline real GDP numbers, while weak, nevertheless overstated strength. The headline numbers were 3.0 percent in the 4th quarter and 1.9 percent in the 1st quarter. Stripping out inventory accumulation, however, leaves real final sales at 1.1 percent and 1.7 percent respectively, and less than 1 ½ percent growth over six months.

We have two consecutive declines in monthly retail sales; monthly jobless claims are drifting back up; industrial production declined in May; and the University of Michigan's consumer sentiment index dropped substantially in May.

While welcome, the recent further decline in inflation reflects weakness. The PPI declined 1 percent in May after a decline of 0.2 percent in April, and no change in March. The CPI declined 0.3 percent in May after no change in April.

Clearly, whatever the case for additional ease by the Federal Reserve, it has increased recently. In terms of the dual mandate, employment/unemployment has worsened while inflation has improved.

What about QE3 or continuation of operation twist?

Operation Twist—the sale of short-term securities and purchase of longer-term maturities to put downward pressure on longer-term interest rates—expires at the end of the month. To end it would probably put some upward pressure on longer term rates and would be taken as a tightening of policy. To continue it may be less of a disappointment to markets, but it is unclear that it would do much new good.

One problem with operation twist is that the security purchases and sales offset each other with no net impact on Fed assets and total bank reserves. The FOMC has said it would replace maturing securities alongside operation twist, but there has really been no net increase in its total

assets in recent months. If additional stimulus is needed, Fed purchases should not be sterilized, or at least not fully sterilized. We need some new growth in Fed assets, bank reserves, and the money supply. Under the circumstances, such growth is unlikely to be inflationary. The growth in money that we've had has been offset by a decline in velocity.

Many say past growth in these variables did no good; so why have more growth. That ignores the counterfactual: what would have happened if the past growth hadn't occurred? I believe that, as in the Great Depression, banks would have tried to satisfy their outsized appetite for excess reserves by shrinking other assets, including loans and investments.

What about reducing interest payments on bank reserves?

One way to encourage banks to utilize their excess reserves by increasing loans and investments and, thereby, pumping up growth in the money supply would be to reduce the 25 basis points the Fed now pays on reserves. I'd hate to see that happen because it took so long for the Fed to get authority to pay interest on reserves, which is an issue of fairness to banks. However, at the margin, given the low level of other short-term interest rates, that should make a small positive difference. Nevertheless, I'd be inclined to vote against this option.

What about doing nothing?

This option has some appeal since "the training wheels have to come off sometime." While I would hate to see this option result in shrinkage of bank reserves and money, some slight upward pressure on interest rates I would welcome. These artificially low rates are distorting the markets, and it's time to relieve the pressure on savers. However, I'd hate to see the negative market reaction to such a bold announcement. Someone said recently, and I don't remember who, that rising stock prices are the only form of stimulus that doesn't involve debt. Maybe the FOMC should purchase a broad index of domestic equities.

What about promising low interest rates beyond 2014?

This is a terrible idea, in my opinion. Of course, I thought the two earlier promises, the latest through 2014 were mistakes as well. They do work to help hold down long term rates now, as long as the Fed is credible, but I don't think the lost of flexibility, and possibly credibility, is worth it.

So, where do I come out?

I could probably be persuaded to go along with the do-nothing option. However, going into the meeting tomorrow morning, I would be inclined to support a statement along the following lines:

"While we are not proposing another formal program known popularly as QE3, or even a formal continuation of the maturity extension program, known popularly as operation twist, we do expect to resume normal open market operations with a view to preventing a contraction in total

Federal Reserve assets and promoting modest growth in bank reserves and the money supply. To the extent that this requires purchases of securities, we will probably choose the longer-dated maturities and will opportunistically purchase guaranteed mortgage backed securities. We do not view this as a major campaign, but as a return to normal discretionary open market operations."