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Fed Likely to Act, but With Minimal Impact

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The Federal Reserve reassured investors this summer that it is poised to act if the economy deteriorates. The central bank is likely to make good on that promise when its policy-making committee meets on Tuesday and Wednesday.

Its actions, however, are unlikely to do much beyond providing some comfort to markets eager for signs the Fed is willing to step in and boost the frail recovery.

“The range of what they can really do and what they’re likely to do is actually really narrow,” said Mark Calabria, director of financial regulation studies at the libertarian Cato Institute.

At its last meeting in August, the policy-setting Federal Open Market Committee said it was weighing the tools available to it and was prepared to use them “as appropriate.”

Those tools include providing further guidance about the likely path of monetary policy, as the FOMC did last month when it pledged to keep interest rates at rock-bottom levels through mid-2013. The Fed could also undertake another round of asset purchases (QE3), further reduce the interest rate paid on excess reserve balances, or increase the average maturity of the central bank’s portfolio, so-called Operation Twist.

The goal of Operation Twist, widely considered the likeliest move by the Fed, is to shift the balance of its $1.7 trillion Treasury portfolio from short-term debt toward long-term debt with the aim of driving down long-term interest rates.

The economic impact of those tools would likely be minimal at best, economists say. And minutes from the August meeting reveal that some FOMC members said that persistent headwinds and recent events leading to a lower path of potential output meant that none of the central bank’s options would have much chance of boosting the economic recovery.

“I don’t really think the Fed can do that much [to boost recovery] right now. I think the economy has got to recover on its own,” said Michael Bordo, a visiting national fellow at the Hoover Institution, adding that the central bank “has pretty well used up most of its policy bullets.”

Ellen Zenter, senior U.S. economist at Nomura Securities International, disagrees. “The Fed certainly isn’t out of options,” she said. “But doing anything more than incremental change at each meeting is going to be a stretch." That's because the FOMC that is coming together on Tuesday is more divided than any in recent memory. If the Fed decides to do nothing, it risks raising dissents from the committee's hawks, who want the central bank to remove its policy accommodation, as well as its doves, who would be upset that no further accommodating action was taken.

The FOMC needs to do more than it did in August to avoid negatively impacting markets, according to Dean Baker, co-director of the Center for Economic and Policy Research. Investors have already priced in their expectations for some sort of help from the Fed, and failure to act could lead to a sell-off, Zentner warned.

"I think they're going to be more activist than they were last time," Bordo said. Although there hasn't been a dramatic decline in the economy, recent economic data, including unemployment and GDP growth forecasts, have been persistently weak.

But a grand gesture pulling out all the stops and deploying all of the Fed's policy tools at once is a bad idea, according to Zentner. The situation in Europe is too uncertain. If "the Fed in one policy meeting throws everything it has got, and the next day you have the announcement of a Greek default, say, then you've just undermined everything the Fed did," she said.

Enacting additional stimulus now also runs the risk of boosting inflation beyond the Fed's 2 percent target without a commensurate gain in output or employment, some FOMC members noted during the August meeting.

That leaves a middle course of action with little impact on the fate of the recovery. With three members dissenting from the August decision to keep the federal-funds rate low through 2013, the mild Operation Twist is likely the only option the 10-member board can agree on internally, according to Fed watcher and University of Oregon economics professor Tim Duy. But those rates are already so low that hardly anyone expects the move to produce a large stimulus, Duy added.

The real impact would rest in its reassurance that the Fed hasn't thrown in the towel, that it's still ready to step in if the economy gets really ugly again.

The FOMC is unlikely to admit there's little it can do to boost growth, Bordo said, "other than in some rhetoric say, 'It's not us; the fiscal authorities have to step in.' Because they've already done that." The Fed is much more likely to emphasize that it will take further action as needed.

The FOMC will release a statement after its meeting on Wednesday.