Fed can't save U.S. economy

Terence Corcoran, Financial Post · Wednesday, Aug. 11, 2010

How bad is it? It's so bad economists are saying the U.S. Federal Reserve will maintain its ultra-loose monetary policy into at least 2012. The Fed itself didn't set an end-game target date in its policy statement yesterday, beyond saying that economic conditions "are likely to warrant exceptionally low levels of the federal funds rate for an extended period." If the loose money effort runs deep into 2012, that would drag the Fed's attempt to boost the U.S. economy into a fourth year.

That's a long time to be messing around with massive monetary stimulus and interest rates that start at a fed funds rate just above zero -- first established in December, 2008 -- and never make it much beyond 3% anywhere else. The yield on short-term U.S. government bills is now well below 1%, but still the U.S. economic recovery isn't getting off the ground. The Fed's statement yesterday opened with a grim review of the current environment, itself a testament to the limits of monetary expansionism:

Information received since the Federal Open Market Committee met in June indicates that the pace of recovery in output and employment has slowed in recent months. Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising; however, investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls. Housing starts remain at a depressed level. Bank lending has continued to contract. Nonetheless, the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, although the pace of economic recovery is likely to be more modest in the near term than had been anticipated.

Exactly why the U.S. economy remains locked in first gear is the subject of much policy wrangling, raising calls for more fiscal and monetary stimulus. The most obvious and logical explanation for the apparent paralysis is that U.S. economy is being held back by the ball and chain of the Obama administration's myriad interventions, regulations and massive fiscal expansion. Some of these items are reviewed in Jim Powell's Cato Institute commentary elsewhere on this page. The Fed seems to think it can overcome the burden of spending, regulation and rising taxes by providing various forms of easy money. The Fed said yesterday that it would keep rates low and keep holding government-based assets at current levels. There were no signs that the Fed anticipated the arrival of deflation any time soon, and thus would not have to prepare for another round of "quantitative easing," which would mean buying whole truckloads of new government debt -- a practice otherwise known as monetizing the debt and printing money so as to promote inflation.

The idea of gearing up a new monetary stimulus program gained new attention the other week when James Bullard, head of the St. Louis Fed, mused about the possibility of the United States heading into a second recession and a period of deflation. If that were to happen, he said, then the Fed could act by cranking out fresh rounds of hundred-billion-dollar quantitative easing.

Mr. Bullard's ideas were somewhat reminiscent of Ben Bernanke's famous 2002 anti-deflation speech. Given before he became Fed chairman, Mr. Bernanke reviewed all the ways that the Fed could easily ward off deflation and keep the economy humming along. "If we do fall into deflation, however, we can take comfort that the logic of the printing-press example must assert itself, and sufficient injections of money will ultimately always reverse a deflation."

Always? Mr. Bernanke's casual and off-hand confidence in the sweeping ability of monetary policy to swing the economic pendulum in 2002 seems unduly optimistic, even arrogant, in today's environment. So cocky was he then, he spoke of unspeakable options, even raising the idea of deliberate currency devaluation.

Although a policy of intervening to affect the exchange value of the dollar is nowhere on the horizon today, it's worth noting that there have been times when exchange-rate policy has been an effective weapon against deflation. A striking example from U.S. history is Franklin Roosevelt's 40% devaluation of the dollar against gold in 1933-34, enforced by a program of gold purchases and domestic money creation. The devaluation and the rapid increase in money supply it permitted ended the U.S. deflation remarkably quickly. Indeed, consumer price inflation in the United States, year on year, went from -10.3%in 1932 to -5.1% in 1933 to 3.4% in 1934. The economy grew strongly, and, by the way, 1934 was one of the best years of the century for the stock market. If nothing else, the episode illustrates that monetary actions can have powerful effects on the economy, even when the nominal interest rate is at or near zero, as was the case at the time of Roosevelt's devaluation.

The United States is not at that door yet. But the mere idea that economic mistakes can be so easily and simply repaired by monetary manoeuvres may only make matters worse if it encourages politicians to adopt populist and misguided policies. As must appear more and more evident at the Bernanke Fed, central bankers cannot be so complacent as to "take comfort that the logic of the printing-press example must assert itself." No amount of printed paper can offset Washington's massive spending increases, unprecedented deficits, program expansions, bank-bashing regulations and anti-growth energy regimes.

Read more: http://www.financialpost.com/save+economy/3383374/story.html#ixzz0wJJinOKq