

Bernanke May Explain Fed Exit Strategy in Testimony Next Week

Craig Torres and Scott Lanman
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(Bloomberg) -- Federal Reserve Chairman Ben S. Bernanke probably will show how the central bank will exit the biggest monetary expansion in history when he reports to Congress next week, economists said.

The Fed pumped \$1 trillion into the banking system over the past year through bond purchases and emergency loans, doubling assets on its balance sheet. Reassuring investors that inflation won't exceed forecasts once the recession ends will give the Fed more credibility, said Dean Maki, chief U.S. economist at Barclays Capital Inc. While policy makers have spoken about specific tools they may use, they haven't laid out a strategy.

"Now is the time to articulate the exit strategy," said Vincent Reinhart, former monetary-affairs director at the Fed and now resident scholar at the American Enterprise Institute in Washington. "The Federal Reserve doesn't speak with one voice and the testimony is an opportunity to present the consensus view."

The Federal Open Market Committee will release updated economic forecasts on July 15. At their April meeting, officials anticipated inflation of between 1 percent and 1.6 percent in 2010, up from 0.6 percent to 0.9 percent this year. Their long-run forecast is for price increases of 1.7 percent to 2 percent.

Investor expectations for inflation have increased this year, as measured by the gap between yields on 10-year U.S. government notes and 10-year Treasury Inflation-Protected Securities. The spread widened to 1.52 percentage point at the end of last week from 0.09 percentage point in January.

Unemployment is also surging: The jobless rate will exceed 10 percent early next year and average 9.8 percent for 2010, according to a Bloomberg News survey published last week. The rate was 7.6 percent in January.

Fed officials will begin to lift the benchmark interest rate in the third quarter of next year and take it to 1 percent in the final three months, the Bloomberg survey showed. The previous month's survey estimated the Fed would hold the rate near zero until the fourth quarter of next year.

"The Fed does not want to trigger market concern about the beginning of policy tightening at this time, an objective I share," said William Poole, former president of the St. Louis Fed. "That means that the Fed needs to be more explicit about how it will know, or what it will look for, to determine that the "appropriate" time has arrived.

This explanation need not, and probably cannot, be very precise; however, there certainly can be some general guidance."

Bernanke is scheduled to address the House Financial Services Committee on July 21. The chairman is required by law to testify twice a year on progress toward the Fed's mandate to achieve stable prices and maximum employment.

“Chairman Bernanke’s semi-annual testimony would be a logical place to lay out these issues in a more detailed discussion,” said Maki at Barclays, who is based in New York. “The more credibility the Fed can cultivate with investors on the exit strategy, the freer it is to pursue stimulative policies in the near-term without leading to sharply higher inflation expectations.”

Bernanke will describe an economy that’s still reeling from the credit crisis that began in 2007 and intensified after Lehman Brothers Holdings Inc. filed for bankruptcy in September. The loss of 6.5 million jobs since the recession began has led the central bank keep pumping money after cutting the benchmark rate to zero.

The Fed has expanded credit through increased loans to banks to provide liquidity and rescues of financial companies such as American International Group Inc. It’s also begun market backstops such as the Commercial Paper Funding Facility, which holds \$109.2 billion in short-term IOUs issued by corporations, and the Term Asset-Backed Securities Loan Facility, which has lent \$24.9 billion to investors to buy securities tied to auto and other consumer and business loans.

The Fed has also pledged to buy \$1.75 trillion in mortgage- backed securities, Treasury notes, and federal housing agency bonds. As of July 9, the Fed had bought \$200.7 billion of Treasuries.

It may take years for the Fed to sell the securities back to investors, said Lou Crandall, chief U.S. economist at Wrightson ICAP LLC in Jersey City, New Jersey. In the medium term, the Fed would need to sterilize the purchases, or find a way to prevent the increased money supply from fueling inflation, he said.

“It will be years before they can start selling, if ever,” Crandall said. “Can they raise interest rates with an expanded balance sheet? The answer is yes. Can they do it in a tidy way? The answer is, we don’t know.”

U.S. central bankers have mentioned reverse repurchase agreements, interest on reserves, and possibly sales of short- term debt as ways to sterilize reserves in the banking system. There are problems with each tool. Under a reverse repurchase agreement, the Fed would sell bonds to Wall Street dealers with an agreement to buy them back at a later date.

Reverse repurchase agreements could require firms that deal directly with the Fed to hold billions of dollars in mortgage securities. “The dealer community and the investor community does not have the appetite to hold a trillion dollars more in mortgages than they are holding now,” said Stephen Stanley, chief economist at RBS Securities Inc. in Stamford, Connecticut, one of 17 companies that deals directly with the Federal Reserve Bank of New York.

Fed officials have also proposed selling their own bills to mop up cash. Congress hasn’t shown interest in the idea, which would require legislation. While the Treasury has a program of short-term bill sales to help sterilize excess reserves, it complicates the department’s regular borrowing to finance government spending.

“I am not worried at all that the Federal Reserve’s balance-sheet expansion will generate an inflation problem,” New York Fed President William Dudley said in a speech in Nashville on April 18.

“The Federal Reserve has the ability to manage down the size of its balance sheet over time once financial conditions and the economy improve.”

That’s what RBS Securities’ Stanley calls the “trust us” approach. The lack of clarity may not ease inflation concerns, especially if the Fed has to increase its purchases of Treasury and mortgage-debt to provide further stimulus to the economy.

Job losses will continue even after the economy begins growing in the second half of this year, the monthly Bloomberg monthly showed.

Tellabs Inc., the Naperville, Illinois-based maker of networking equipment, said last week it's scrapping about 150 jobs. Dow Chemical Co., the largest U.S. chemical maker, said July 1 it will permanently close three Louisiana factories and take a second-quarter charge of about \$700 million. Midland, Michigan-based Dow's charge includes the elimination of 2,500 jobs, following the acquisition of Rohm & Haas Co.

The Reuters/University of Michigan preliminary index of consumer sentiment fell by more than forecast in July to 64.6 from 70.8 in the previous month. Consumers in the survey said they are less likely to buy cars or appliances, suggesting the recovery may be weaker than anticipated.